THE FREEMAN

IDEAS ON LIBERTY

The Growth of Government in the United States

Io Leggo e Scrivo

Freedom and Democracy Are Different

AUGUST 1990

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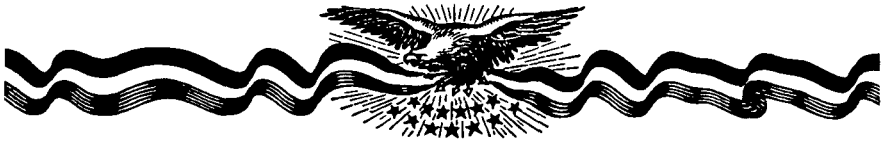

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IDEAS ON LIBERTY

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PERSPECTIVE

Is the Post Office Efficient?

Whether or not mail should cost more to deliver depends on whether there are cheaper or better ways to deliver it. That's not something to be settled by talk because both sides can argue forever. The way to find out if the job can be done cheaper and better is to let other people try.

We have already found out from experience that the United Parcel Service can deliver packages better than the post office. A number of private overnight delivery companies are thriving in competition with the post office. In neither of these cases do we have to waste our time listening to rhetoric or looking at statistics to make a decision. Each of us can make his own decisions as to how we want to send packages or overnight mail.

Unfortunately, when it comes to the basic mail services—the letters and postcards—we are forbidden by law from having a choice. Even when you buy your own mail box, the federal government forbids anybody except the post office from putting anything in it.

It is only because the Postal Service is a legal monopoly that decisions about it have to be made through a process of political hot air instead of a process of competition in the marketplace.

—THOMAS SOWELL
writing in the
March 16, 1990, *Houston Chronicle*

Social Security

In contrast to nurtured common misconception, Social Security is *not* a program of personally funded pensions. It is *not* a process of individuals accumulating their own retirement accounts.

Rather than a saving process of building retirement funds, the operation is inevitably consume-as-you-produce for the community as a whole and pay-as-you-go in financing retirement benefits. Indeed, since Social Security tax payments now are much greater than benefits dispersed, it is a pay-*more*-than-you-go scheme. Today's workers are *not* accumulating money which will be retured to them years later; instead, today's workers are paying taxes to finance benefits for today's retirees—and to finance other government spending, as well. . . .

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No bookkeeping "trust fund" accumulated *today* will take care of *tomorrow's* retirees. The community and its government will have to provide and pay for *tomorrow's* benefits out of *tomorrow's* production and income.

—WILLIAM R. ALLEN
The Midnight Economist

Drugs, Values, and Self-Control

The popular notion of drug addiction to such hard drugs as heroin and cocaine says that those who take such drugs will inevitably increase their intake until they reach a point where the craving for the drug high and the fear of withdrawal causes them to lose control. The loss of control is evidenced by the willingness to sacrifice all—to the point of self-destruction—to ingest the drug. This popular belief in addiction is buttressed by animal research that allegedly shows that monkeys will press a lever to get more cocaine until they kill themselves. The monkeys cannot help themselves because the addictive power of cocaine is so great.

Critics dispute the "monkey model" of addiction. Other research suggests that animals will not choose drugs when they have a choice and when studied in a natural environment. Furthermore, the view that addiction is the automatic result of a biological process is contradicted by millions of "controlled" users of such drugs as alcohol, marijuana, amphetamines, and even cocaine and heroin. The controlled users regulate their intake of drugs because their self-image, value system, and self-discipline keep them from descending to the "depths of addiction" as it is commonly perceived. The controlled users simply decide to limit their intake of drugs.

Thousands of American soldiers in Vietnam became "addicted" to hard drugs, but only 14 percent remained "addicted" upon their return to the United States. The 86 percent who quit simply decided that they did not want to get involved in the American drug culture. Their value system and self-discipline helped them to "Say No."

Don't misunderstand me. I do not favor experimentation with drugs. I do not use drugs, and I do not approve of or associate with those who use drugs. But the focus on the overpowering and addictive nature of drugs has led us to ignore the issues of values and self-discipline.

It seems to me that the worst thing we can do is tell those who are greatly tempted to continue the use of drugs that they will reach a point where they will lose control and can't help themselves. That message erodes their effort toward self-control. Those who study the psychology of control tell us that a belief in the ability to control is needed to ensure maximum effort toward self-control. The message that one has lost control may contribute to "learned helplessness" and greatly erode the ability to exercise self-control.

—WILLIAM LEE WILBANKS
Professor of Criminal Justice
Florida International University

Developing a Market Economy in Eastern Europe

A market economy must be built from the market up—from the very arena in which the day-to-day decisions of buyers and sellers methodically and objectively allocate the available resources to the most efficient producers. To assume that a market economy can be dropped into place by the orders and edicts of central planning agencies is to make mockery of the term "free market."

A free market is built on the foundation of voluntary exchange between economic actors. There is nothing at all voluntary about government edicts. A government, especially a government still committed to socialist principles, cannot legislate a market economy into being. One might just as well claim that a few adjustments on a worn-out engine will fill the tank with gasoline. It's the gas that fuels the engine, not the other way around! Likewise, it's the commitment to free markets that dictates the principles of government that will be exhibited in any society.

A free market can be based only on the foundation of individual liberty, which includes the freedom to own property. Belief in the ability of government to "create" free markets by legislative fiat belies a lingering faith in the efficiency of socialism—whatever form it may take. And if there is one lesson to be learned in Eastern Europe, it is that socialist economies are unworthy of such a faith.

—JOHN S. VIEHWEG
Mesa, Arizona

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THE FREEMAN
IDEAS ON LIBERTY

Io Leggo e Scrivo

by James L. Doti

Giuseppe Doti was a reader and writer. He had other jobs that paid money, but when asked what he did for a living, he would say, "Io leggo e scrivo."

After emigrating to America, he found his ability to read and write a rare talent in the Chicago community known as Little Italy. Illiterate immigrants needed a sympathetic soul-mate to read and write letters passing to and from the old country. His letters arranged marriages, kept waiting wives and lovers content and, in general, soothed the ravaged nerves and aching anxieties of disconnected people.

In reading and writing letters, Giuseppe grew to understand the very soul of a person. His ability in conveying a person's passions and petty pretensions with dignity and spirit made him a reader and writer of the first rank. Giuseppe was conscious of his high calling and devoted following, and he dressed the part.

Upon returning home in the evening after work, Giuseppe had his dinner and then his toilet. After meticulously grooming himself and spending an inordinate amount of time trimming a Hitleresque mustache instead of the hair he no longer had, he would put on a freshly laundered white shirt and starched collar. Giuseppe always sported a maroon tie that he felt complemented his piercing blue eyes. The double-breasted tweed suit he generally wore made him appear even shorter and stouter than he actually was. And although he had a noticeable limp from a stroke he had suffered several years earlier when he was 63, Giuseppe forsook the use of a cane, which he felt to be more suitable for a person much older than he.

Every evening he listened to the phonograph that invariably played a Puccini or Verdi opera between 7:30 and 8:00, but at 8:00 sharp, he retired to a back room of his humble flat to receive his clients.

They would come and sit expectantly in the kitchen, clutching their letters, anxiously awaiting the reading that would relieve or justify their heaviest anxieties. Upon entering the back room, they would clasp Giuseppe's hand in both of theirs and then silently present a non-monetary offering. Feigning surprise, Giuseppe would refuse acceptance of the offering until the giver's insistence reached the appropriate level of intensity. At that point, the charade would end by Giuseppe humbly tilting his head and bowing in acceptance.

The abundant quantities of homemade wines, basement-cured salami, prosciutto, and mortadella, dried pepperulo, canned giardiniera, and aged provolone cheese amassed by Giuseppe were ceremoniously doled out by his wife Irena to their children and grandchildren. Irena drew the line once when she refused to admit into their flat a recent immigrant who brought a live chicken as a token of appreciation. When word of this spread through Little Italy, it reinforced the neighbors' opinion that Irena's noble lineage made her too proud to dress a chicken.

Giuseppe already had taken care of three clients when he got up to greet Bruno Pucci, a recent

Dr. Doti is Professor of Economics at Chapman College, Orange, California.

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Giuseppe Doti

immigrant, bearing a crumpled letter and bottle of homemade Chianti. For once, Giuseppe was greatly pleased to receive an offering. It was well known that Bruno Pucci's family made the finest wine in Little Italy.

Bruno sat and looked at the room around him. Unlike most Italian-decorated rooms that were thick with heavy furniture and religious ornamentation, this room was sparsely furnished with a card table and two chairs. The room was illuminated by a single light bulb dangling at the end of a three-foot cord. Two yellowed etchings, one of Marcus Aurelius and the other of Dante Alighieri, ornamented the heavily cracked walls.

Handing the letter to Giuseppe, Bruno said, "I'm-a worry about Italia, Signore Doti. Dey vote-a for Mussolini, and who know what dat-a jackass gonna do."

After carefully unfolding the letter and slowly putting on his wire-rimmed reading glasses, Giuseppe read the letter to himself. If there were deaths or other tragedies to report, Giuseppe wanted to be prepared. This was a practice he learned several months earlier after reporting the death of a woman's 98-year-old aunt. Upon hearing of her aunt's untimely demise, the lady fell to the floor and began a rhythmic wailing that continued even as her relatives dragged her out of the flat.

To Giuseppe's relief, the letter from Bruno Pucci's father had no deaths to report. He poured Bruno a glass of wine and pushed a platter of freshly baked biscotti toward him. Giuseppe then read in Italian:

March 13, 1936

My dear son,

Italia is changing. We don't have to put up with King Victor Emmanuel and his national assembly. We voted for Il Duce Mussolini and his party and hope things will change for the better. He made the trains run on time, won the war in Abyssinia and now that his party controls the national assembly, we think he will make our country work. You should return to your homeland and family and be part of a new Italia.

Giuseppe recognized the work of another reader and writer, Vito Abboduto, a competent writer to be sure, but one whose maudlin style injected into the letters a more depressing mood than even the dour Italian peasants were inclined to exhibit. Giuseppe continued reading to Bruno.

Mussolini's party bosses came to our town last week and told us we can increase our wine production by everyone working together. The party bosses promised us that the government will buy all the wine our town makes at top dollar if we turn over all our equipment to the state. A workers' representative will be in charge of making the wine, but each family will have one vote to re-elect him or throw him out at the end of the year.

I have been told to work on the grape-crushing unit. I will miss making our family wine, but we will make more money by working with the government.

Your mother misses you and cannot understand why you left us. She is worried you are not eating enough, and it is too cold in Chicago. You are too young at 34 years old to be away from home. The women here in Italia make bet-

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ter wives and are not so independent as in America. We heard of a woman in America who left her husband because she would not shine his shoes. What kind of world is that?

Come home, my son. Our cousin, Tito Cimino, the local constable, promised me he can get you an easy job that pays well on the grape-picking unit. Your mother and father need you, my son. We are sending you a large photograph of us so you don't forget us.

Your loving father

When Giuseppe stopped reading, he looked and saw in Bruno Pucci's catatonic stare the burden of guilt that seemed to smother the lives of so many recent immigrants. Giuseppe said nothing and waited for Bruno to speak. When he did, he spoke slowly and softly with his tear-filled eyes pointed toward the floor.

"Signore Doti, I look at that-a picture they send-a me and my father looks-a me like I kill-a somebody and my mother looks-a sad like she gonna die. But I can't-a go back. Please write a letter for me."

Giuseppe picked up his Schaeffer fountain pen and began to write the words Bruno spoke in Italian.

April 23, 1936

My dear Mama and Papa,

I eat well. Uncle Rocco and Aunt Maria take good care of me. It is good to be with family here. I help Uncle Rocco make wine at night and work at his grocery store during the day.

Yesterday we threw out a batch of wine when we found dead rats that fell in the fermenting vat and drowned. I told Uncle Rocco that no one would know any difference when they taste the wine, but Uncle Rocco said our family honor is at stake.

Bruno caught Giuseppe suspiciously eyeing the bottle of wine he had brought and said, "No Signore Doti, don't-a worry, I brought-a you good-a wine. We dump-a the bad wine down da sewer."

Giuseppe raised his hands deferentially to indicate no concern on his part but at the same time decided to tell Irena to give the gift bottle of wine to his newest son-in-law, Fiore.

Bruno took out a folded money order from his wallet and sliding it over to Giuseppe continued his letter.

Because we lost so much wine with the rats, I can only send you a little money this time. Next time I send you more.

Your loving son,
Bruno

Another Letter

Giuseppe had almost forgotten about wine, Mussolini, and rats when Bruno returned, letter in hand, more than half a year later. This time Bruno did not bring wine, but two tickets to the Friday night fights that he inserted in the palm of Giuseppe's hand. Giuseppe, who hated violence of any kind, including boxing, was thinking of what son-in-law to pass the tickets onto as he led Bruno to the back room.

Giuseppe silently accepted the letter that Bruno had shakily handed to him. The fact that there were no stamps on the envelope was an indication that the letter had been smuggled out of Italy. This was a common practice ever since Mussolini's secret police started routinely censoring letters mailed out of the country.

As he read the letter to himself, Giuseppe decided to prepare Bruno for the unhappy contents by sighing audibly and shaking his head several times in disbelief. Giuseppe was not being inconsiderate. He long ago had discovered that people are much happier receiving news that was not as bad as they had imagined after observing his exaggerated lamentations. He then began to read:

October 2, 1936

My dear son,

Things are terrible here. Food and coal are scarce. Thank God our cousin Tito Cimino gives us extra rations or else I don't know how we would survive.

We increased wine production this year, but the government did not pay us much for it. I don't blame them. It is terrible wine. We picked the grapes too early when they were still watery. We told the workers' representative that this would make terrible wine with no character. But we make more wine that way, and he has a production quota to fill.

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Now we can't get rid of the workers' representative. We all vote for him even though he is an idiot. He controls all the jobs, wages, and favors. So what can we do? Nobody can travel anywhere even to find work in other cities without his approval. We can't even make our own wine anymore since we gave our press, grinder, and fermentation vats to the government. So nothing is ours any more. That is why we bow and scrape to all the party officials so our meager existence does not become even worse than it already is.

Poor Italia is going to the dogs. And we keep voting to give that jackass Il Duce more and more power. To get anything nowadays, you have to know people in the government, and then when they do you a favor, you belong to them and they have your vote.

Since the secret police censor all the letters now, I had to wait for a friend who was returning to America to bring this letter to you. The government also owns all the newspapers now. That is how they control everything that is written. The big crowds that cheer "Duce" are there because the party bosses force the owners to let their workers attend the rallies. But things keep getting worse and worse.

Cousin Tito can still use his pull to get you a job if you want to come back. Your mother does the wash for the local party official, so we can also get favors from him. Mother worries about you being away from us. But as bad as things are here, maybe it is better that you stay in America.

Our love to your Zio Rocco and Zia Maria. I don't know what your mother would do if she didn't know you were being taken care of by family.

Your loving father

When Giuseppe had finished reading the letter, he stepped out of the room to leave Bruno with his private thoughts. He returned with a bowl of chestnuts that Irena had just roasted.

After grabbing several chestnuts, Bruno said, "Our families make-a da best-a wine in Italia. Now whadda dey gonna do?"

Realizing that Bruno did not want his questions answered, Giuseppe asked if he wanted to send a letter.

"Si, Signore Doti. But please you write-a da letter. Tell-a dem dat you have opportunity in Amerega. Tell-a dem that I love Amerega and cannot-a go back."

He gave Giuseppe a money order to enclose with the letter, and then he left the flat after placing a handful of chestnuts in his pocket.

Giuseppe would be able to write the letter for Bruno. For like Bruno, he had left his own parents to make a new home in America. He knew the pain and guilt one felt in leaving one's parents and homeland. He knew the fear and isolation one felt in arriving in a new land where an unknown language was spoken and an unknown people lived. And he knew both the exhilaration and intimidation one felt in experiencing a new-found freedom that made it possible to succeed or fail on a grand scale. So he knew what Bruno was feeling and he wrote.

December 2, 1936

My dear Mama and Papa,

I cry when I hear of your struggle. Sometimes I dream how good it would be if you were here to share our lives together in my new country, America. I dream you are here to taste the freedom I have tasted and see the opportunities I have seen.

America is a nation of justice. Like Italia, there are crooked politicians and government bureaucrats with their palms out asking for favors. But we have rights that protect us from their injustice.

America is a nation of hope. Like Italia, there are people who look down on others because of their family background and education. But we have opportunities that make it possible to improve ourselves so we can live better lives.

Life is not easy here. I have a job, go to school, help Uncle Rocco make wine, and take extra work when I can get it. But for the first time in my life I don't feel the system holding me back. So while you say Tito Cimino can get me a job, he cannot give me the hope and dreams I have for a better life. A job in Italia is a way to put food on the table, but a job in America is a way to get a better job.

When Mussolini came to power, you had dreams for a better Italia, an Italia where the government would help the people lead better

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lives. I too remember the rising expectations of people every time we had a new national assembly under King Victor Emmanuel. But I grew frustrated when each government took more from the people than it gave.

In America, we rely on ourselves, not a government, to improve ourselves. We are in control of our destiny. And while this freedom places additional responsibility on us for what we do with our lives, it is better than placing false hopes in others.

Many people say America is great because everyone has the right to vote. But I remember we voted in Italia and things always got worse instead of better. What makes America great is not our right to vote but the rights we have that protect us from those for whom we vote.

I hope and pray you will understand why I will not return to our beloved homeland. Please always know that my love and thoughts are with you.

Your loving son,
Bruno

Giuseppe lit his pipe and began reading the letter to himself. As he read, distant memories of his parents and homeland were reawakened. Giuseppe found it strange that though his parents had died long ago, he still felt a heavy burden of guilt for having left them.

It was late. The rest of the flat was dark and quiet. Giuseppe wearily got up and turned down the space heater before joining Irena in bed. As he fell asleep, his last waking thoughts were his hope that Vito Abboduto would read the letter to Bruno's mother and father with the same intensity and emotion with which it was written. □

Freedom and Democracy Are Different

by John T. Wenders

The earthshaking events of the past few months in Eastern Europe have generated surprise, shock, hope, and applause throughout the world. The most important consequence of these events, however, is not the demise of authoritarian socialist governments, but the impetus given to an examination of the relationship between the private and public sectors in all nations.

Contrary to the media hoopla that equates democracy with freedom, the mere replacement of a Communist socialist government with a democratic socialist one, while an improvement, does not alone advance the cause of freedom very much.

Freedom and democracy are different. Democracy addresses how affairs in the public sector will be conducted. Democracy is greater when individuals vote on those matters assigned to the public sector. On the other hand, freedom is concerned with the relationships among people in the private sector. Freedom means individuals may choose how to interact on a voluntary basis outside the purview of the state.

In short, democracy means you get to vote in the public sector; freedom means you get to determine the terms of your interactions with others in the private sector.

John T. Wenders is Professor of Economics at the University of Idaho.

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The popular news and debates over reform in Eastern Europe have focused on the developments toward democracy in the public sector to the neglect of the more important question of how human activities are divided between the public and private sectors. One can envision a country with an authoritarian, but very small, public sector in which freedom is much greater than in a country with a democratic, but very large, public sector.

The key is a constitution that draws the line between the public and private sectors, and between democracy and freedom. More important, the role of the constitution is to protect freedom from democracy and the individual from the majority.

Some freedoms are civil, like free speech, religion, and association. The First Amendment takes the regulation of speech, including the press, out of the public sector. Left to a democratic political process, free speech would be severely restricted by lawmakers—invasions of free speech are repeatedly being struck down by the courts, and many more are prevented by these precedents. The Constitution protects free speech from democracy.

In the economic sphere, freedom means that individuals have a right to own, buy, and sell property as they choose in free markets. In the past century, there has everywhere been a steady invasion of market activity by the political process. Even in capitalist countries such as the United States, the public sector has continually expanded. Once economic activity is addressed by the political process, it immediately becomes subject to capture by those—often a tiny minority—who can effectively manipulate it to their own ends. In many ways this political invasion of the marketplace throttles free speech as well, as witnessed by the successful efforts of newspaper trade groups, normally staunch defenders of free speech, to prevent competition from telephone companies who wish to enter into electronic publishing.

The economic collapse of Communist socialism is largely responsible for the upheavals of the past year. Yet the popular notion is that this economic collapse can be repaired by a democratic reform of the political process. On the contrary, economic reform can be achieved only by removing economic matters from the political process. Unless the size and scope of the public sectors in Eastern Europe, now all-pervasive, are shrunk considerably, little will have changed. The only difference will be that people acquire the right to vote on how the public sector constrains their freedoms.

The lessons of the past are clear, if Eastern Europe chooses to look. Wherever economies are heavily regulated (as in Eastern Europe, China, North Korea, India, most of Africa and South America), socialist or not, they have been outstripped by their market-oriented counterparts—Western Europe, Japan, South Korea, Taiwan, Hong Kong, Singapore, Chile, the United States, and the Commonwealth nations.

The constitutional bases for a market economy are very simple: property rights must be vested in individuals or voluntary associations of individuals. These rights, like our freedoms of speech and religion, must be well defined and tenaciously defended (as is free speech) against encroachment from the public sector. Titles to property and services must be freely transferable.

The objection to keeping the public sector out of private economic activity is that markets don't always work ideally. Yet the same people who condemn the marketplace for not working ideally want to scrap it for a politically directed system that is demonstrably worse. Rational choices can be made only by weighing the benefits and costs of alternatives. Only individuals can know their alternatives, and only individuals who directly bear the consequences of their choices will weigh these properly. Filtering choices through complex political and bureaucratic processes assures that the alternatives will be neither known nor weighed. Markets are certainly not perfect, but they are much better than the alternatives, as events in Eastern Europe have shown.

There is a difference between democracy and freedom. Freedom must be protected from democracy. A good constitution will do that. Only when the countries of Eastern Europe and elsewhere adopt and enforce such constitutions will the economic progress that inevitably follows be realized.

In our own economy the dangers of public encroachments on the private sector are usually encountered more subtly. Here, we have produced a massive public sector by tolerating incremental encroachment without addressing the larger issue. If nothing else, the recent events in Eastern Europe should stimulate us to rethink the drift of piecemeal democratic encroachments on our own freedoms. □

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The Growth of Government in the United States

by Robert Higgs

Big government—we heard a lot about it when Ronald Reagan was first seeking the Presidency. Lately the topic has attracted less attention from politicians, commentators, and scholars. But the thing itself has not disappeared. Over the past decade, as over the past century, American government has continued to grow.

Our nation was founded by men who believed in limited government, especially limited central government. They were not anarchists; nor did they espouse laissez faire. But they did believe that rulers ought to be restrained and accountable to the people they govern. If the founders could see what has happened to the relation between the citizens and the government in the United States during the past two centuries, they would be appalled.

The size and scope of government are important for many reasons. By virtue of their taxing, spending, and regulating, governments affect the allocation of economic resources, the distribution of wealth, and the rate of economic growth. Governments determine the very nature of our political economy, the character of the social organization within which we may lawfully conduct our affairs and pursue our goals. The size and scope of government determine—they are, so to speak, the opposite side of—our freedoms.

All but the few anarchists among us recognize that effective liberty requires *some* government, if only to define and protect rights to life and property. Beyond a point, however, bigger government begins to cut into our liberties; then the growth of government becomes synonymous with the sacrifice of liberty. In the United States, we entered this stage a long time ago.

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Charting Government's Growth

When we say that government has grown, what do we mean? Government is not a single thing, measurable along a scale like inches of height or pounds of weight. The size of government can change in different dimensions, many of them incommensurable.

One dimension of government is the burden of taxation. In the early years of the 20th century, federal, state, and local governments took in revenues equal to 6 to 7 percent of the gross national product (GNP). By 1950, revenues had risen to 24 percent of GNP. Over the past 40 years the tax proportion has drifted irregularly upward, and now stands at about 32 percent of GNP.

Many people seem to think that taxes were cut in the 1980s, perhaps because certain politicians worked hard to create the impression and to take credit for it. The truth, however, is that overall —that is, considering all taxes together—taxes as a percentage of GNP were slightly higher at the end of the 1980s than they were at the beginning of the decade. The tax laws were changed repeatedly, and some tax rates were reduced, most notably the top rate of the Federal individual income tax. But other taxes were increased, most notably the payroll tax rate and the base earnings on which it is levied. Altogether, there has been no tax cut.

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Another dimension of government—and an even more appropriate index of its fiscal burden than tax revenues—is government spending. In the early years of the 20th century, federal, state, and local governments spent an amount equal to 6 to 7 percent of the gross national product. By 1950, government outlays, net of intergovernmental grants, had risen to 21 percent of GNP. Over the past 40 years the spending proportion has drifted irregularly upward, and now stands at about 34 percent of GNP.

Many people seem to think that a so-called Reagan Revolution cut government spending in the 1980s. In fact, nothing of the kind happened. Government spending continued to grow rapidly, and relative to GNP it was slightly greater at the end of the 1980s than at the beginning of the decade. Of course, some forms of spending grew relatively slowly, some relatively rapidly, but overall government spending grew faster than the private economy.

Still another index of the size of government is government employment. Early in the 20th century, federal, state, and local governments employed about 4 percent of the civilian labor force. By 1950, government employment had risen to about 10 percent. During the past 40 years, government employment rose and fell: it reached a peak in the mid-1970s at nearly 16 percent, then fell to its present level of roughly 14 percent—that is, one worker in every seven. (This figure doesn't include the two million members of the armed forces.)

Although the employment ratio seems at first glance to indicate a recent decline in the government's size, one should not jump to that conclusion. Many people who are classified as members of the private labor force actually work for governments as contractors (or employees or subcontractors of contractors). Between 1980 and 1987, for example, about a million additional workers found jobs in the defense industries—virtually all of them, obviously, working on projects set in motion and financed by the government. Similar changes have occurred elsewhere as governments have "privatized" more functions by contracting out the performance of tasks previously performed by workers on the regular government payroll. It would be a mistake to suppose that government has shrunk just because regular government employment hasn't kept pace with the growth of the labor force.

Increased Regulation

Indexes of government taxing, spending, and employing tell us something about the growth of government, but what they tell us is far from the whole story. Even if government had grown in none of these dimensions, it might have become a bigger factor in determining the allocation of economic resources, the distribution of wealth, and the rate of economic growth. It could have done so—and in fact it has done so—by means of increased regulation.

I refer to regulation in its broadest sense, including the legal requirements expressed in statutes, executive orders, and judicial decisions as well as the directives of regulatory agencies such as the Environmental Protection Agency and the Securities and Exchange Commission. The shelves are sagging under the growing weight of such authoritative commands—just skim through the *Federal Register* some time if you are willing to risk becoming deeply depressed, or, for an even more profoundly depressing experience, attempt to read any recent regulatory statute, say, a consumer protection law. Tax laws also are de facto regulatory statutes, and perhaps the most incomprehensible of all legislation.

In regulation we come face to face with the visible hand of government at work imposing largely hidden costs. The costs are hidden in part because they are borne by private parties in the process of compliance—meeting prescribed standards, avoiding prohibited actions, and so forth—and spread across the consuming public in the form of higher prices for goods and services.

But that cost, great as it is, is not the whole. In large part the costs of an economy extensively controlled by government requirements and prohibitions take a form no one can compute: these costs arise when governments distort the price structure so that mutually beneficial exchanges are never made, so that new products never reach the market, so that new competitors never gain entrance into an industry, so that innovations of countless different sorts are never made, there being no prospect of profit to stimulate their development in the first place.

Americans, despite much habitual grumbling, are proud of their economy, which continues to rank among the world's most productive. What we have done, we can see and appreciate. But what we

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might have done, the miracles we might have wrought had we been free to do so, we shall never know. In this sense, the costs of an ever more regulated economy are truly incalculable.

But what of the recent deregulation we have heard so much about? Yes, something did happen along those lines. In energy, communications, transportation, and certain financial services, the heavy hand of government lightened somewhat in the late 1970s and early 1980s. By the mid-1980s, however, the steam had gone out of the deregulation movement, and little significant progress has occurred during the past five years.

Meanwhile, offsetting increases of regulation were taking place in other areas, including international trade and finance, environment, safety, agriculture, aerospace, insurance, and health services. The multi-billion-dollar bailout of the farm credit system might have deserved prominent mention had it not been completely overshadowed by the gargantuan bailout of bankrupt savings and loan institutions. In view of the mind-boggling magnitude, it is remarkable how little political debate surrounded this transfer of—who knows? $300 billion? $400 billion?—from the taxpayers to a select group of hard-lobbying beneficiaries.

Standing back and surveying all the regulatory changes, plus as well as minus, during the past decade, what can we conclude? I defer to the judgments of William Niskanen and Murray Weidenbaum, two of the best informed students of the subject. Niskanen concludes that "the net amount of regulations and trade restraints has increased" since 1980, and Weidenbaum says that "the federal government, objectively measured, is a bigger presence in the American economy today than when Jimmy Carter left office." So much for deregulation.

The Reasons for the Growth

So, government is still big, and government is still growing in the United States. Why? To answer this question, we need to understand some history. To start with, we need to find out whether American government was ever really small and, if it was, what made it get bigger.

You may recall from your school history text that the United States government in the mid- and late-19th century adhered to the doctrine of laissez faire—the doctrine of hands off. Well, that lesson conceals more than it reveals. In fact, in important respects the label of laissez faire shouldn't be applied at all. At no time did the United States fully achieve the condition denoted by the term *laissez faire.*

From about the 1840s to the 1890s, however, the United States approximated perhaps as closely as any large society ever did a condition we might call the minimal state. Certainly, governments didn't spend or tax on anything like the modern scale—5 percent of GNP would probably overstate the ratio. (We must rely on imprecise estimates, so we can't say for sure.) Not many people worked either directly or indirectly for governments, certainly no more than a few percent of the labor force even at the end of the 19th century. By these familiar indexes of the size of government, the 19th-century government appears to qualify as a minimal state.

And yet, to say that government was much smaller in these dimensions is not to say that the governments of the 19th century were unimportant or that Americans were reluctant to politicize essential economic questions.

Most important, governments established the legal framework of property rights within which the price system could operate to allocate resources. As economic conditions changed, governments molded the law to new conditions and allowed economic growth to continue relatively unimpeded by obsolete legal restraints. Innovation of the doctrine of eminent domain, for example, played a crucial role in permitting construction of the canals and railroads that did so much to facilitate economic development.

In addition, the central government episodically committed the nation to war—at times to wars of conquest such as the Mexican War that added vast territories to the country's expanse. Governments disposed of the public domain, transferring the bulk of it, by sale and giveaway, into private ownership. Governments collected various taxes, including the tariff that was employed to carry out what nowadays would be called an "industrial policy." Governments invested in and regulated banks and transport systems; they supplied education; and at the local level they conducted the countless interventions subsumed under the heading of "the police powers," many of which would be found intolerable in our time. Before the Civil War, governments sustained the institution of slav-

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ery, a matter of momentous economic consequence as well as an arrangement so violently incompatible with higher American ideals that today no one would defend it. In sum, governments in the 19th century, though in most respects far more limited than governments today, were hardly insignificant.

In certain respects, 19th-century conditions made it possible for governments to be much smaller than they are today and still wield great power over the economy. Nineteenth-century governments didn't spend a lot of money to enrich politically influential parties. But they enforced slavery, a momentous matter all by itself; they disposed of the public domain (Federal railroad subsidies alone transferred an area roughly twice the size of Colorado); and they managed property rights in fundamentally important ways. One reason modern governments do so much more by means of taxes, subsidies, and pecuniary transfers is that they lack some of the powerful means available to their predecessors—millions of workers to hold in thrall, a continent to give away.

Having acknowledged that laissez faire never was the case, and that even at its smallest, American government engaged in extremely important activities, we must recognize that governments still might have been much bigger than they were during the 19th century. One way to confirm this potential is to notice that, occasionally, government did get much bigger. During the Civil War the U.S. government not only increased its taxing and spending hugely; it also printed and spent fiat paper money, overrode a variety of civil rights, including the writ of habeas corpus, and conscripted men to serve in the army. After the war, however, the government shrank—not quite to its prewar dimensions, but back to a more traditional scope nonetheless.

At the end of the 19th century, James Bryce, a perspicacious British commentator, noted that America's poor, long invested with political rights, might easily have turned on the rich and "thrown the whole burden of taxation upon them, and disregarded in the supposed interest of the masses what are called the rights of property." But, Bryce went on to say, "not only has this not been attempted—it has been scarcely even suggested . . . and it excites no serious apprehension." There was, he observed, "nothing in the machinery of government that could do more than delay it for a time, did the masses desire it." What prevented such sweeping redistribution was, in Bryce's judgment (and mine), the prevailing ideology. In Bryce's words, "equality, open competition, a fair field to everybody, every stimulus to industry, and every security for its fruits, these [the Americans] hold to be the self-evident principles of national prosperity."

A Revolution in Ideology

Obviously, somewhere along the line, the dominant ideology of the United States has undergone a complete revolution. I exaggerate only a little if I say that now most Americans believe that governments may legitimately give to people or take away from them virtually anything, any time, any place—checked only by the license conveyed by government officials' having been elected in the Constitutionally sanctioned manner. Where once Americans viewed the powers of government as properly limited and the rights of individuals as primary and natural, Americans now view the powers of government as properly unlimited and the rights of individuals as subordinate to the pursuit of any declared "public policy." How did so many activities once viewed as "not the proper business of government" come to be undertaken by governments and accepted as legitimate?

I have no short, definitive answer. The process by which the dominant ideology of the American people changed over the past century is surely complex, and no one understands it fully. It is possible, however, to identify certain critical aspects of the process.

Ideologies are, to a large degree, the product of people's social experience. Although polemicists and propagandists are always at work, they don't work in a vacuum. Ideas appeal to the public more or less, depending on how they seem to fit the broad contours of reality. When great events happen, ideologues always stand ready to interpret in a preconceived way what has happened, but again they are constrained by undeniable facts. It just wasn't possible, for example, to interpret the Great Depression as a triumph of capitalism.

With the economic transformation of the United States in the late 19th century, a process that witnessed rapid urbanization and the growth of big business as well as many other striking developments, collectivist views began to gain adherents here, as they did throughout the Western world.

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The ideological shift became quite striking during the Progressive Era at the beginning of the 20th century. It was not unconnected with such consequential institutional changes as the Income Tax Amendment to the Constitution and the creation of the Federal Reserve System. So, clearly a tendency existed, rooted in the changing character of American society and economy and related developments abroad, moving American opinion leaders away from support for individualism and private property rights and toward support for collectivism and more active government involvement in economic affairs. By itself this tendency would have helped to promote the growth of government. But the secular tendency of ideology was hardly the only aspect of ideological change to affect our political economy in the 20th century.

National Crises Contribute to Shifting Views

Even more important, in my view, was the succession of national emergencies that struck the country between 1914 and 1945, and to a lesser degree during the postwar era as well. Clearly the world wars and the Great Depression had the greatest impact, although the period from the mid-1960s to the mid-1970s also witnessed many significant events. How did these crises contribute to shifting American views about the proper role of government in economic life?

In brief, the process worked as follows. First, each crisis gave rise to public clamor that the government "do something." In the post-Progressive era, no government wished, nor could rulers expect to prosper politically if they chose, to keep their hands off the economy when a problem of overriding public concern had arisen. So, whether to prosecute a war or to alleviate a depression or to suppress a great labor upheaval, the government adopted interventionist policies to deal with the crisis.

Any government policy entails costs. The greater the costs, the less willing the public is to support the policy. Hence governments face a hard choice: on the one hand they cannot just stand by, because the public demands that they act; on the other hand, any policy they adopt is subject to the law of demand, which means that, in the extreme, the public will reject a government that imposes unbearably large sacrifices on the citizenry. How can the government get off the horns of this dilemma?

The short answer is: adopt policies that obscure the costs as much as possible. One way to do so is to avoid policies that entail pecuniary (and therefore easily counted, aggregated, and publicized) costs; instead, adopt command-and-control policies whose costs tend to be hidden or extremely difficult to compute and aggregate.

For example, if an outright gift of public funds is made to farmers, everyone can see how much the government is taking from taxpayers in order to give to farmers. But if the government adopts crop restriction programs, the costs are spread across all those, including foreigners, who purchase the farm products whose supplies have been restricted. Who can say how great the transfer is? Indeed, many people will never appreciate the redistributive aspect of the program, as they would if an explicit farmer-benefit tax had been enacted and added, say, as a separate item on the income tax return.

Other prominent examples include the conscription of men into the armed forces, the suppression or restriction of certain industries or products during wartime, the establishment of priorities for the supply of selected goods and services, the rationing of consumer goods, and a whole array of price, wage, and rent controls that distort the structure of prices and alter the allocation of resources, benefiting some while placing burdens on others. The common aspect of all such policies is that their costs are more or less hidden, and hence the political reaction to them is muted.

When the government adopted cost-obscuring policies during the great national emergencies, officials also undertook massive propaganda efforts to justify their actions. No doubt many citizens believed what their leaders told them about the virtues of the policies. In addition, during each crisis the administrators of the controls finessed them to eliminate some of their most objectionable aspects, and people more readily swallowed the medicine when its bitterness was diminished. All the while, people tried to make the best of a bad situation, and many discovered that even a controlled economy offers certain avenues to personal success, either within the government itself or within the favored sectors of the remaining "private" economy. People adapt.

But here is the crux: they adapt not just their

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actions but eventually their thinking, too. In William Graham Sumner's telling phrase, "it is not possible to experiment with a society and just drop the experiment whenever we choose. The experiment enters into the life of the society and never can be got out again." People who had experienced the abruptly enlarged government programs of the national emergency periods came away from those experiences with an altered view of the benefits and costs, virtues and vices, of an expanded government presence in American economic life. Further, in each case, committed collectivists took advantage of the event to hammer home the point that what the government had done, apparently with success, during the crisis demonstrated the great potential for good that lay in expanded government action even during normal times. To many people, the argument seemed to make sense. After all, we had won the war, we had got out of the depression.

In retrospect and with careful study, one can see that people were committing the fallacy of *post hoc, ergo propter hoc.* In many cases, if not in all, the genuine benefits accruing to the nation as a whole—escape from the depression, defeat of the Nazis—came forth in spite of, not because of, the government's imposition of sweeping controls. But, again, people in general didn't reach this conclusion. Rather, they tended to accept the collectivist claims or, more cynically, to appreciate that even if the country at large might suffer, they themselves now had a grip on a personally rewarding piece of the statist program.

By the end of World War II the United States had altered its effective Constitution radically from the regime in place at the beginning of the 20th century. Now virtually any government action whatever in relation to the economy could be taken, so long as an electoral majority could be obtained by its initiators. In a political economy so corrupted by interest-group politics, an electoral majority was itself something that could be bought, indirectly if not directly. There remained no fundamental check on the growth of government—nothing to perform the restraining functions that the old Constitution and the dominant, limited-government ideology had performed in the 19th century. Politicians now could offer to sell virtually any economic policy whatever, no matter how few the gainers and how many the losers. Of course, such conditions were tailor-made to bring forth special interests prepared to buy the policies from the politician-suppliers.

In the welter of largely contradictory policies, deadweight costs mounted enormously. More and more resources were devoted simply to working for or against economic policies and to circumventing or adapting to the proliferating requirements imposed by government. Not surprisingly, more and more latent interest groups saw the need to organize for political action. By the 1970s the entire economy had been thoroughly politicized, so that even the most intimate matters, such as babysitting services or nursing homes or the religious calendars of employees, had become subject to government intervention. A few years ago, Grace Commission investigators discovered that the federal government alone was conducting 963 separate social programs, many of them designated "entitlements." America's political process has become the locus of organized predation on a massive scale.

The growth of government cannot continue forever. An economy totally dominated by government isn't viable—even the Communists now recognize this. Eventually the government will eat up so much of the private sector that it will destroy the means of its own sustenance. At some point the balance of political power will swing away from support for bigger government in an effort to revive the dying goose that lays the golden eggs. If such reaction can occur in the Soviet Union and Eastern Europe, it certainly can occur here.

But that glorious day, in my judgment, is not yet in sight. Despite the plethora of burdens laid on the American people, the private economy retains sufficient vitality to limp along at a modest pace, albeit far slower than a truly free economy could progress. And the American people continue to demand, or at least to tolerate, a multitude of government programs promising solutions to almost every conceivable problem. So long as the dominant ideology lends support to collectivist measures and acquiesces in a political system dominated by special-interest deals, no far-reaching reform of our political economy is possible. So, as we look into the future of the United States in 1990, as far as the eye can see, we behold only big government and more big government. □

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The Last Wild Children of Capitalism

by William B. Irvine

American futures markets have long played the role of villain in popular economic thinking. In his 1903 novel *The Pit*, for example, Frank Norris offers his readers the following description of the Chicago Board of Trade:

> Within there, a great whirlpool, a pit of roaring waters spun and thundered, sucking in the life tides of the city, sucking them in as into the mouth of some tremendous cloaca, the maw of some colossal sewer; then vomiting them forth again, spewing them up and out, only to catch them in the return eddy and suck them in afresh.

Elsewhere in *The Pit*, Norris drops the sewer metaphor and instead describes in realistic fashion the action on the trading floor. Here, for example, is his description of the opening of trading on the Chicago Board of Trade:

> Instantly a tumult was unchained. Arms were flung upward in strenuous gestures, and from above the crowding heads in the Wheat Pit a multitude of hands, eager, the fingers extended, leaped into the air. All articulate expression was lost in the single explosion of sound as the traders surged downwards to the center of the Pit, grabbing each other, struggling towards each other, tramping, stomping, charging through with might and main.

It was probably Norris, as much as any author, who was responsible for creating the image of futures-market-as-madhouse.

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This novelistic image of futures trading has not only survived the passage of time, but has been enhanced by the advent of television. Broadcasts from commodities exchanges demonstrate that Norris did not exaggerate: Futures exchanges are wild—some would say surrealistic—places.

All these images have had an impact. Ask most Americans what futures traders do, and they'll tell you that futures traders are adult men and women who make vast fortunes by standing in a circle, gesticulating wildly, and shouting at each other. In the minds of many Americans, futures traders resemble frenzied gamblers on a casino floor or participants in a contact sport whose rules are particularly demented. Should such people, many Americans wonder, be allowed to play a role in the shaping of the American economy? Indeed, should such people be allowed to roam the streets freely?

Even among those who are not swayed by this image of futures traders, there has been considerable antipathy towards futures markets. This antipathy is founded on the belief, common among many intellectuals, that futures markets play no significant economic role and have no socially redeeming value; instead, they exist simply so that greedy people can make fortunes at the expense of farmers, small investors, consumers, and other "little people."

A Growing Distrust

In the last few years, the traditional distrust of futures markets has grown apace as the result of two events. The first was the 1987 stock market crash. Many investors, regulators, and theoreti-

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cians pointed an accusing finger at stock index futures as being partially responsible for the crash. The second event was the criminal investigation (still under way) into trading abuses on the floors of various futures exchanges, abuses that allegedly included cheating customers, market manipulation, fraud, and tax evasion.

As the result of this double blow, the future of American futures is in doubt. There are a number of people calling for regulation. "Shouldn't the government do something about futures exchanges," they ask, "particularly if the members of these exchanges are corrupt or if their trading activities can cause stock market crashes?"

Should we, then, "do something" about American futures markets? Would greater government regulation be advisable? Indeed, should futures trading be banned altogether? In what follows, I would like to defend futures markets as an economic institution and inquire into the proper role that the government should play with respect to these markets. There is, I think, a role for the government in futures markets, but I think this role stops far short of the kind of heavy-handed regulation that many have called for.

Before I begin my defense of futures markets, a few words of explanation are in order.

To begin with, a futures contract, as its name implies, is a contract between individuals. Whereas many contracts (e.g., a bill of sale for a car) specify an immediate exchange of goods, a futures contract specifies an exchange of goods at some future date.

Although individuals can draw up "custom made" futures contracts between themselves, there are advantages to using the standardized contracts traded on futures exchanges like the Chicago Board of Trade or the Comex in New York. For one thing, at organized exchanges it is much easier to find someone with whom to enter into a contract; and if one later decides to "back out of" the contract, it is much easier to find someone willing to assume the contract in question.

By *buying* a futures contract, one becomes obligated to take delivery of a certain amount of a certain commodity for a certain price on a certain date. The commodity in question can be something mundane like orange juice or pork bellies (from which bacon is made), or it can be something exotic like palladium, or something intangible like a "basket" of common stocks. In parallel fashion, by *selling* a futures contract, one becomes obligated to deliver a certain amount of a certain commodity for a certain price on a certain date.

Who Buys Futures Contracts?

Who would buy and sell such contracts? And what would motivate them to do so? Many Americans think that the only people who would buy or sell futures contracts are speculators, and that the motive of these speculators is greed. In fact, speculators are only one of the groups who participate in futures transactions. The other major group consists of the producers and consumers of various commodities—i.e., businessmen, farmers, and other sober-minded types.

A farmer might, for example, want in July to lock in the price of the wheat he will harvest in September. Selling a futures contract enables him to do so. Conversely, a baker might want in July to lock in the price of the wheat he will need in September. Buying a futures contract—say, from the farmer just mentioned—can give him the price guarantee he seeks. Thus, when the farmer sells a futures contract to the baker, the transaction serves the interests of both; and both would be worse off if they were prohibited from entering into the contract in question.

Futures contracts, then, can be seen as a form of insurance, but instead of insuring people against loss of or damage to a physical asset like a house or a car or a crop of wheat, futures contracts "insure" producers and consumers of a certain commodity against price changes in the commodity in question. In other words, futures contracts function to shift the risk of price changes from the producers and consumers of a commodity to speculators, who are willing to assume the risk in question in return for the chance to profit from doing so.

It should thus be clear that by buying and selling futures contracts, people are engaging in one of their most basic economic rights, the right to enter into contracts with other individuals. This in turn means that when the government curbs the activities of futures exchanges, the government is to some extent infringing on the right of Americans to enter into contracts with others.

Furthermore, the right in question is not an abstract right, but a right, the violation of which can do real harm to real people. For notice that in

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a free society, people enter into a contract only if they judge that it is in their best interests to do so. When the government steps in and prevents people from entering into contracts or places restrictions on the contracts they can enter into, it is blocking them from doing what they take to be in their own best interests.

It is true that the parties to a contract may be mistaken about what is in their best interests. However, a case can be made that people generally have a far better idea of what is in their own interests than politicians do. Indeed, someone sophisticated and affluent enough to trade futures is generally someone who has demonstrated his competence in handling practical affairs; not every politician or government regulator can say as much. This suggests that we should leave it to people to decide what contracts they should enter into—and this in turn means leaving it to the futures exchanges to set the rules for trading contracts and to determine the standardized form contracts should take.

What if people don't like the contracts or trading rules offered by a futures exchange? What if they think the rules or contracts are unfair? Then they won't trade on the exchange in question; they will instead trade on other exchanges (whose rules or contracts they like better) or they won't trade at all. Notice, however, that it is in the interests of futures exchanges to offer the public the contracts and trading rules that they desire; for the only way that members of an exchange can make a living is if people are willing to do business at their exchange. When thinking about this issue, we should also keep in mind that in America there exist several different futures exchanges competing for the business of futures traders.

The Proper Role of Government

Does this mean that the government should have no role at all in the operation of futures markets? By no means. Most people agree that one proper role of government is to act as the enforcer of contracts into which individuals have entered. If you make a contract with someone and he fails to live up to his end of the deal, you can seek compensation in a court of law. Thus, if a futures exchange does not live up to its own rules—and fails to compensate those who are thereby harmed—the courts should enter the picture.

In summary, leave it to the futures exchanges to design standardized contracts and to set trading rules; leave it to the government to take action when futures exchanges fail to enforce the rules they have set.

Some will complain that in making the above remarks I ignore the fact that events on futures exchanges can harm the economy in general (say, by causing stock-market crashes) and thus can affect Americans everywhere. Since the events that take place on exchanges can harm "innocent bystanders," they will maintain that the government is playing an appropriate role when it tells exchanges how to conduct their business.

In reply to this criticism, two comments are in order. First, it is far from clear that events on futures exchanges can cause stock market crashes. This, at any rate, is an issue on which economists are divided. Second, even if events on futures exchanges *could* cause stock market crashes, it is far from obvious that stock market crashes harm the economy in general.

Along these lines, Nobel laureate Milton Friedman has argued that stock market crashes need not destabilize the economy. Those who are skeptical of this claim should recall the events of 1987: America witnessed a particularly severe stock market crash, but it had little effect on the economy. Not only didn't we have a depression, we didn't even have a recession.

Other economists have argued that financial crashes, although painful in the short term, can be beneficial to an economy in the long term. After all, these crashes, by wiping out marginal (and presumably inefficient) enterprises, keep the economy in fighting trim. By way of analogy, a herd of reindeer will, in the long run, be far healthier if there exist packs of wolves who pick off diseased and deformed reindeer, whose presence would otherwise jeopardize the overall health of the herd. It is true that stock market crashes have their victims, but a case can be made that society as a whole (and in the long run) is better off with these victims than it would be if it tried to create an economy in which marginal businesses were protected from destructive economic forces.

This brings us back to Frank Norris's image of the Chicago Board of Trade as a great whirlpool, as the maw of a colossal sewer. I think that the whirlpool image is correct. What one sees at a futures exchange are the surface effects of much

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On the floor at the Chicago Board of Trade.

deeper currents. The currents in question are the economic forces of supply and demand. And if futures exchanges are whirlpools, then traders on those exchanges are like swimmers caught in a whirlpool: Some swimmers will benefit from the currents of the whirlpool, and others will surely drown. (This explains the panicky atmosphere in the trading pits of exchanges.) And although there may be traders who momentarily control the course of the whirlpool, no one is strong enough to control it for long; and those who try to are often destroyed in the attempt.

Norris was wrong, however, in presenting us with the image of futures exchanges as sewers, for these exchanges, rather than sucking in and then vomiting forth the life tides of a city, replenish the tides in question: Futures exchanges help far more people than they harm; and those they harm, more often than not, are speculators who knowingly and willingly exposed themselves to the risk of harm in return for a chance at profit.

Futures exchanges present a tempting target for government regulators. Even in the best of times, the public distrusts futures exchanges, and recent controversies surrounding these exchanges have made their political position weaker than ever. One can only hope that futures exchanges will retain their independence in coming years. We will all be poorer should regulators succeed in taming these last wild children of capitalism. □

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Patience and Property: Corporate vs. Union Management

by Dwight R. Lee and Robert L. Sexton

Managers who anticipate a short tenure with their firm unsurprisingly have little interest in long-term solutions to its basic problems. Their goal is to look as good as possible in the immediate future.
—ROBERT REICH, The Next American Frontier

It is a commonly held belief that corporations, in pursuit of short-term profits, short-change the future. This alleged emphasis on the short run is seen to create a host of problems such as an eroding industrial and human capital base, a productivity crisis, a lack of competitiveness in world markets, the energy crisis of the 1970s, mounting levels of corporate debt, and environmental pollution. The solution advocated by Robert Reich and others is to substitute more control by representatives of government and labor. However, this would be a terrible mistake.

Property Rights and Incentives

Individual decision makers, whether acting as managers, union leaders, politicians, or workers, will appropriately weigh the future when it is in their interests to do so. This is the reason why private property ownership is critical to efficient, future-oriented economic decisions. If property rights are well defined and enforced, then current owners will benefit from any foreseeable increase in the future value of resources they control. And, if private ownership rights are *transferable,* this will provide the incentive for individuals to concern themselves with outcomes that extend far into the future.

With corporations, transferable property rights exist in the form of shares of stocks. Since corporate stocks are easily transferable, any management decision that is considered to inhibit a corporation's long-run wealth position will be translated quickly into lower stock prices. On the margin, it takes only a few to recognize short-sighted business policies of management. Once this mismanagement is translated into lower stock prices, even relatively uninformed shareholders will notice and understand that it may be time to call their broker. Thus, transferable property rights in the form of stock reflect the future consequences of corporate decisions.

However, unions do not have the equivalent property rights, and that is why the long-run wealth effects of present decisions are not clearly registered in a way that feeds back into union decisions. This leads to several important implications. One, without transferable property rights (which reflect the present value of employment opportunities in a firm or industry) the control of union members over union management is restricted. To some extent, union members have control over union management through their right to vote on some issues and on their union leaders. Therefore, members can restrict union management from deviating too far from the collective interests of the members. However, any union-member voter has little motivation to be informed since a single vote will not likely have a decisive impact on any decision, and each worker's time horizon

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extends only as long as his employment tenure.

This is not the case with corporate stockholders. They have much more control over their agents than union members have over theirs. The stockholder has the ability to buy and sell stocks. In order for union members to protect themselves in an equally effective way against poor union management decisions, they would have to change jobs and move to an employment setting with either a different union or no union at all. Hence, union leaders have a greater ability to maximize their personal goals and advantages and promote their own agenda than corporate managers, since union members have little or no effective recourse. In other words, unlike the market for corporate control, the market for union control is very ineffective.

Consequently, union decisions on many issues do not correspond with the interests of the members. The position unions take is often at odds with the political preferences of their members. Professors Dan Heldman and Deborah Knight found that in a majority of questions posed to union members in opinion polls, their positions differed (sometimes diametrically) from the positions which their union leaders were lobbying in Congress.

But, even if unions were perfectly responsive to the concerns of union members, they would still tend to be insensitive to future wage and salary decisions. Since workers don't own transferable "employment stock" that reflects the long-run value of their jobs, they have little incentive to take the long view when balancing current wage demands against the long-run gains from maintaining and expanding a productive capital base. But owning employment stocks would require that workers own their jobs with the right to sell them to whomever they please. This would remove the control over employment decisions from those who have supplied the capital and hence would greatly increase the costs of raising large amounts of capital.

However, when workers are in charge of management decisions, this often leads to myopic investment practices. For example, in worker-managed firms in Yugoslavia, employees are entitled to residual profits, but claims are retained only if the worker remains with the firm. So, it is in the workers' best long-term interests to take their higher wages out of the firm in order to invest in items which have a permanent title (for example, furniture or jewelry) rather than investing in the long-term capital needs of the firm. This is true even when the returns on capital far exceed those of alternative investment opportunities.

Under reasonable property rights arrangements, workers will be less sensitive to the long-term employment effects of current salary, wage, and investment decisions than will corporate managers whose current compensation and future prospects are directly tied to the performance of the firms they manage, as reflected in stock prices. It is current compensation that is often used as a monitor of union effectiveness. And union leaders who cannot extract current wages and benefits from employers will fall under the wrath of their members.

Political Influence of Organized Labor

Unions have been adept at influencing the political process in support of legislation that increases their control over business decisions. There are two explanations for their political influence. One, members of labor unions are intensely concerned about short-run wages and fringe benefits. Such narrowly focused groups are more easily organized and generally are more politically effective than are groups with more diverse interests. Two, political action is best when an organized self-interest is able to disguise itself with the rhetoric of a noble cause. This is particularly evident in labor unions that work under the guise of struggling for the well-being of workers. But higher wages in the union sector tend to depress wages in the nonunion sector, so it is easy to see that union workers' gains come at the expense of nonunion workers. Thus the real battle that unions wage is not against business, but rather against nonunion workers, who often would be willing to work for less than the union scale.

Unions have effectively been able to project the image, however, that they are dedicated to the protection of workers' rights against the arbitrary so-called power of big business. Union-supported legislation that restricts the discretion of capital owners or corporate management is often politically popular because it is perceived as a justifiable means of curtailing exploitative business practices. This may explain the political appeal of minimum wage laws, maximum hour restrictions, and other

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legislation that limits the ability of employers to negotiate with employees.

Unions also have been active in support of political measures to *restrict* corporate practices that serve to motivate corporate managers to concentrate on the long run. For example, takeovers, mergers, stock options, and bonuses provide important incentives for management to consider the future consequences of current decisions. Another example is a corporate arrangement called "golden parachutes" where corporate executives are compensated if their jobs are terminated as a result of a takeover or merger. It is argued that this type of arrangement provides incentives for corporate executives to take risks in line with what their diversified shareholders would consider appropriate and not to fight takeovers that would be in the shareholders' interests.

Union myopia will affect future productivity in at least two ways. First, in anticipation of a union's negative impact on the return to capital, one would predict that the projected equity value of a newly unionized firm, or one threatened with unionization, will fall. Second, in those industries in which union power is strongest, one would expect that wage demands eventually will reduce the industry's competitiveness and, in the absence of government bailouts and protections, push it into serious decline.

The filing of a union election petition and the results of that action can impose significant costs on a firm. Based on data from 1962 to 1980, a successful union drive against a firm lowered the firm's stock by 3.84 percent. According to Professors Richard Ruback and Martin Zimmerman, even the threat of unionization in the form of an unsuccessful union effort resulted in a 1.32 percent decline in the firm's stock price.

The reduction in returns to current and potential investors reduces an industry's investment appeal. Hence, capital formation will be retarded by the effects of unionization. Also, lower profitability in union firms will hamper the internal market for capital, a very important source of efficiency within firms.

One way to reduce the burden of union wage demands is by substituting capital for labor. And, indeed, one can be sure that the *ratio* of capital to labor will, over time, increase in response to excessive wage requirements. Whether this substitution effect will motivate an absolute increase in the amount of capital isn't clear *a priori.* But, even if the amount of capital in the industry actually increases, it will be the result of a union-induced distortion in the capital-labor mix that will reduce both the efficiency of the industry and its ability to compete.

The union myopia that motivates excessive wage demands has been detrimental to the long-run well-being of all interests in the economy —consumers, providers of capital, and employees alike. But this economically destructive shortsightedness is the completely predictable consequence of political action that increases the power of unions over business decisions and over the allocation of business profits. Political attempts to rescue unions from the plight in which they find themselves—attempts which ordinarily involve granting them yet more power and imposing still more restrictions on business decisions—will prove just as self-defeating in the long run as have previous attempts.

Labor unions already have given worker representatives more control over business decisions than most people realize. This control has hampered the ability of business management to pursue long-run goals through far-sighted and productive investment commitments. Private business concerns may not give the future the weight that, in some ideal world, would be considered appropriate. But a realistic assessment of the motivations driving labor union activity leads to the unmistakable conclusion that giving more control over business decisions to labor unions will shorten the planning horizon of business firms.

As long as owners and managers of private businesses are free to allocate revenues among shareholders, employees, and capital investment in response to market forces, decisions will be made that promote capital formation and lead to long-run economic growth. Unfortunately, government regulation of labor relations has increasingly diminished businesses' (and therefore consumers') control over decisions relevant to capital investment, and passed that control to union officials. As a result, government has shortened the planning horizon of business decisions, allowed excessive wages to be substituted for capital formation, and reduced the long-run competitive vitality of major sectors of the U.S. economy. □

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A Tale of Two Estates

by Andrew E. Barniskis

This is a tale of two estates in Bucks County, in eastern Pennsylvania. Actually, it's a story about a single piece of real estate, but one that's had two identities during my life.

In the early 1950s, when I was a boy, it was a millionaire's estate. It was private property—"Trespassing Strictly Forbidden"—but a creek ran through the property, much of its several square miles was covered by woods, and it held an irresistible lure for boys. Looking back, I realize that the fishing in the section of creek that ran through the property was probably no better than in the sections outside its borders, but sneaking quietly through the pine-covered hills to fish in one of the forbidden pools was an adventure that magnified perceptions of both the size and the number of fish.

The estate was patrolled by caretakers, and we all knew stories of terrible things that had befallen boys caught trespassing. But it never seemed to have happened to anyone we knew personally —the stories were always about some kid a couple of towns over, who went to a different school. The only time I came close to getting caught was when I went with a buddy who started being loud and began breaking down small trees. After that I always went alone, and never came close to being spotted again.

One day after I had made an early morning foray into the estate, I was returning home along one of the dirt roads through the woods when I heard a horse-drawn vehicle approaching. That was unusual, because by the early 1950s all of the local farmers used tractors, and the few horses still around were kept for riding. As I hid in the bushes, I saw a strange sight—an elegant carriage filled with young men and women dressed in 19th-century costumes, laughing and joking as four beautiful black horses pulled them along.

To this day, I don't know the reason for their summer morning costume ride, but I remember the thoughts it brought to me then and over the years: How wonderful the world could be, that some people could indulge in elegant play in the middle of a weekday! While my own father worked at exhausting labor and neighboring farmers cursed their rusting machinery, here were grown people who could play midday make-believe, with accouterments that probably cost more than what most of my father's acquaintances would make in a year. I may not have cared much for fancy horses, or even for well-dressed young ladies at the time, but that vision of what was attainable in life influenced me greatly over the years.

Sometime between my boyhood and my early adult years, the estate acquired a new identity. The millionaire owner died and willed the property to the state. Eventually it was turned into a state park. From being the property and plaything of a few rich individuals it became the property of everyone—at least, in theory. Nevertheless, its former identity would once more pique my imagination.

After working for several years following high school, serving in the Army, and saving my money, I started working my way through a local college as a laboratory assistant. One day I was in the laboratory with a professor when the conversation turned to the old estate. Coincidentally, a mainte-

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nance man who was working with us had been a caretaker on the estate in his younger days. He didn't need much prompting to begin pouring out stories of the extravagant, eccentric lifestyle of his former employers—the lavish parties, the dozens of servants, the grand cars, the small fortunes spent on the whims of a moment.

My professor, a true English gentleman and a sincere and outspoken socialist, was horrified and quite literally shaken: "How terrible that anyone should have so much . . . ," he finally managed to stammer. As his student, I nodded false agreement, while thinking, "No—how wonderful!"

I was one of the professor's better students. I wondered what he thought kept me at my studies until well past midnight—dreams of working on rusting tractors, or of moving crates in a warehouse? Certainly not. I'd done those things. It was a vision I had seen that life could be much better than most of what had surrounded me while growing up. If I hadn't thought that something much, much better was attainable, I would have been out drinking with my friends, instead of studying.

I sought out the maintenance man several times and extracted as many of his stories of the old estate as I could. Many was the time, while in college, that reflecting on one of those tales would spur me to continue working an extra hour or two, after everyone else had turned off their lights. Along the way I had decided that "having so much"—whether it was wealth or academic success—had to start with work.

The New Vision

Years later the estate—now in its new, public identity—was to provide me with one more vision. I took my young son to the park to see if the old, secret pools still produced fish. We didn't have any luck because some noisy kids were throwing rocks down from the cliffs. Also, many of the old natural landmarks had been vandalized, so I couldn't find the best pools. When we got back to the parking lot, a motorcycle gang was drag racing, openly smoking dope, and smashing beer bottles while a powerless park guard looked the other way.

As one by one, intimidated young families packed their picnics to leave, I looked at the tableau before me—the scruffy motorcyclists charging wildly around the lot, framed against the elegant old mansion, still standing on the overlooking hill—and thought, this is the triumph of the Marxist vision. The proletariat has inherited the capitalist's estate. Why are so few rejoicing?

I suppose that you could count the number of people who visit the park each year, and argue that more people get more good out of the estate now than when the millionaire owned it. Of course, there are annual lawsuits by those seeking to prevent the hunts the state holds to control the deer herd, and there probably will be a lawsuit filed by some bicyclists, who have just been told they can't use the woodland roads because they interfere with the horseback riders. There always seems to be some sort of political contest going on over how the park will be used. And, while the state makes a genuine effort, it's pretty hard to gather up all the trash that people can spread over several square miles. The Fish Commission gave up stocking the creek several years ago.

I've known the estate in its two identities, and I know what its old identity taught me. But my son has seen it only in its public identity. I wonder what it has taught him? Possibly, that in the world of collective ownership, things owned by everyone are cared for by no one, and that control then belongs to those with the power or arrogance or brutality to take it.

I know that I can tell my son about values and virtues and the work ethic. But there are no words that will have the impact of the vision he saw at the park that day. □

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Municipal Services: Unfair Competition from Local Governments

by Bill Tomlinson

I recently saw an ad in our local paper in North Vancouver, British Columbia, which set me to thinking. The advertisement announced that a team of consultants had been hired by the municipal government to "establish strategies for the provision of parks and recreation services" in our city and the surrounding community. The announcement implied that as our population grew there would be a greater need for these services, and the municipal authorities should provide them.

On the face of it this might seem a reasonable proposition, since throughout North America we have become accustomed to having local authorities supply certain services, and there is nothing unusual about finding public parks in any city or village. Likewise many communities provide recreational facilities such as ice rinks, stadiums, swimming pools, and playing fields; and the great majority of residents raise no strong objection to having a portion of their tax money spent this way.

However, I began to look back on the course of events since we moved to North Vancouver 22 years ago, and it became clear that a pattern had developed. When we arrived we found there were two exercise clubs serving the community. Each had an ice rink, curling rink, swimming pool, saunas, and exercise room. Each was in competition with the other for members, but they had a far more serious adversary.

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Two or three years earlier the city had embarked on a major construction project—a recreation center with an ice rink, curling rink, swimming pool, saunas, and exercise room. As things turned out this was to be just the start of a burgeoning empire, as over the years three more facilities featuring ice rinks and swimming pools have been built in the district to accommodate the growing population. At present another pool with a special wave action feature is out to tender. In the meantime the two private clubs struggled on until one succumbed in the early '70s. The other went into receivership in the early '80s, but has remained in operation on a limited basis.

In the late '60s and early '70s there was a surge in the popularity of tennis. An entrepreneurial group put up a building to provide covered courts, and the parks department paved over sections of several parks and put up nets and fences. Since we live in a temperate climate where you can play tennis outside all the year round, many people chose to use the "free" courts, and the indoor club failed.

Exercise clubs come and go with regularity. A few have even survived and seem to be prospering. In spite of this, it is reasonable to assume that among those that didn't survive are some that could have done so if they hadn't been beaten down by the double hammer blow of competition from municipal recreational programs and the taxes they were paying to subsidize those programs.

The same scenario has been repeated in other

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municipal services. Public libraries supplanted the private lending libraries. Similarly, in many communities, schooling, garbage collection, water supply, and fire-fighting services were provided by private firms until they were put out of business by unfair competition from local governments. Apologists for interventionism twist the argument around by claiming that government action is needed because the market fails to supply affordable services. We must be on our guard against the notion that because there is little or no direct cost, some services suddenly become worthwhile.

Many of us are aware of the dangers of socialism, and the influence it has had on politicians at the national level. But I wonder how many people are taking notice of the assaults on our property rights and civil liberties that are taking place week by week as local authorities introduce new programs. We must educate ourselves and help others to learn the difference between voluntary and coercive action, and we must involve ourselves in the affairs of our communities. Perhaps it will be by concentrating on local issues such as these that we will be able to stem the tide of collectivism. □

Misdirected Compassion

by Douglas Mataconis

Nearly every day we are confronted with newspaper and television stories about society's less fortunate members—families living in squalid conditions, and homeless people sleeping on the streets of America's greatest cities. Understandably, these stories are shocking to most of us; no one in a country such as ours, we say to ourselves, should be reduced to living in conditions like these. Someone should "do something" about it.

Unfortunately, this urge to help the poor typically leads people to believe that only government-sponsored programs can provide the needed aid. Whether the proposed remedy is a government-mandated "living wage," rent control laws to ensure "affordable" housing, or other interventionist policies, the underlying premise is that compassion for the poor demands that we increase the size and scope of government. When we look at the results of these policies, however, we see that government intervention doesn't improve the lot of the poor; in fact, it often worsens the situation.

Supporters of the minimum wage, for example, assert that the poor should be helped by insuring that their jobs pay a wage that meets their basic needs. That sounds reasonable and compassionate. However, what if a worker's productive output is less than the minimum wage? In this case, the very people who are supposed to be helped by the minimum wage—the low-skilled working poor—are hurt the most, since employers are less likely to hire them at this new, higher wage. As a result, a law that was passed out of compassion for the needy produces higher unemployment and more deprivation.

The results are similar with rent controls. In this case, a law is passed to make housing more affordable for those with low incomes. Again, this sounds reasonable and compassionate. The actual result of such a law, however, is to reduce the supply of affordable housing. By setting a ceiling above which rents cannot rise, such laws prevent landlords from earning returns comparable to oth-

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er investments, such as stocks or bonds, that require less time and fixed capital. Thus, investors are discouraged from building new low-income housing or maintaining properties they already own. Once again, a law that was passed out of a sense of compassion for the poor does the greatest harm to precisely those it is supposed to help.

One is led to ask: If we really care about the less fortunate members of society, why do we pass laws and implement policies that make them worse off than they were before? It would be far better practically and morally to abandon this blind faith in the state's ability to help the poor, and search for a better way to assist those in need.

For example, instead of a government-mandated minimum wage, we should allow employers to pay what they believe the labor in question is worth, in light of competitive market conditions. Admittedly, there will be people who will be earning less than what many would consider "decent," but isn't it better that these people be employed at a job paying $3.00 or $3.25 an hour, and thus gain the experience needed to advance and earn more, rather than be unemployed under a system where the government has decreed that wages cannot fall below $4.25?

Similarly, we would find that a free market in housing is the best way to alleviate the crisis in low-income housing. Whereas now in many cities the only area of housing attracting investment is high-income housing, rent decontrol would restore the profit incentive to low-income housing. We would find that, at least initially, the costs of low-income housing in cities currently practicing rent control would probably rise but, as investors re-enter the field, competition from new and refurbished housing would drive rents lower.

There is nothing wrong with feeling compassion for the poor. Human charity, so long as it isn't coerced, is admirable. Problems develop, however, when compassion is misdirected into policies that actually worsen the plight of the poor. If this compassion is genuine, then those who feel it must abandon these policies and recognize that the best remedy for poverty lies not in a larger and more powerful government bureaucracy, but in an expansion of the free market and the opportunities it provides for everyone. □

IDEAS ON LIBERTY

Franklin Pierce on Public Charity

I readily and, I trust, feelingly acknowledge the duty incumbent on us all, as men and citizens, and as among the highest and holiest of our duties, to provide for those who, in the mysterious order of Providence, are subject to want and to disease of body or mind; but I cannot find any authority in the Constitution for making the Federal Government the great almoner of public charity throughout the United States. . . . it would, in the end, be prejudicial rather than beneficial in the noble offices of charity. . . .

—from a Veto Message, 1854

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The Social Security Trust Fund: "Savings" vs. Saving

by Richard W. Fulmer

For every person receiving Social Security benefits in 1950, 17 others were employed. By 1970 the ratio had dropped to three workers per beneficiary, and as postwar baby boomers reach retirement age early in the 21st century, that ratio will drop to two-to-one. In the year 2030, workers will be paying an estimated one-third of their wages to support Social Security recipients.

Originally the program was intended to be pay-as-you-go, with receipts equaling disbursements. With insolvency looming, however, Congress in 1977 and 1983 decided to increase tax revenues beyond current expenditures and "save" the difference for future needs through the purchase of government securities. In practice, however, the purchase money is spent on current programs, and the "Trust Fund" is left with IOUs—thus Social Security tax receipts aren't "saved" in any meaningful sense.

Proponents of the "Trust Fund" scheme argue that the government is simply investing in Treasury notes in the same way that a private citizen might, and, like the citizen, can expect a return on the principal when the notes are redeemed. But how is this "return" to be generated? The money isn't being used to produce wealth, but rather is spent on current consumption. Investors must bank on the government's future ability to sell more notes (i.e., to keep the pyramid growing) or, failing that, to collect more taxes.

If taxes are used to buy back the IOUs, then we are left with the original problem: workers are still footing the bill. The only difference is that now the total is split between F.I.C.A. and the general tax fund. Actually, the workers would get some relief since corporations and Social Security recipients must also pay into the general fund, but the benefits of corporate participation would be offset by resulting price increases, reduced capital investment, lower wages, and higher unemployment.

In any case, the same amount of "relief" could have been realized by simply declaring that Social Security would be supplemented directly by general revenues rather than by shoveling those revenues in through a back door. The big difference, of course, would be that then the politicians wouldn't get to spend the money from the "savings fund."

Real Saving

Saving must be more than the mere husbandry of paper dollars. Ultimately there must be something for those dollars to purchase—production must precede consumption. True saving is an increase in real wealth, not dollars. As Adam Smith pointed out, increased wealth can result only from greater production which, in turn, can be achieved only by raising the number of productive laborers

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or by improving the efficiency of laborers already employed. This cannot occur without additional capital investment. Capital is required for the maintenance of new workers or for the development of better methods or machinery.

An increase in the nation's productivity leads to a larger tax base from which tax revenues may be drawn. Therefore, the best long-term investment any government can make is to allow the private sector to retain its capital so that production can grow.

If, instead, the government takes more money from the market than it currently needs so as to form a "savings fund," it erodes its own tax base. In the end, the creation of such a fund *reduces* future tax income, and wealth isn't saved but lost.

The Smoke Screen of Consumption

Keynesians counter that such government action doesn't reduce production or productive capacity since the money taxed away from the private sector remains in circulation. Ultimately government expenditures wind up in the hands of consumers—government employees, contractors, members of the armed forces, and beneficiaries of Federal programs—who purchase goods through the market. This increased consumption, it is argued, raises demand for products and spurs industry to ever greater production.

In reality, however, consumption isn't increased by government spending; it is only *transferred* from some individuals to others. And this transfer reduces productive output. As Adam Smith explained in *The Wealth of Nations*: "The whole, or almost the whole public revenue, is in most countries employed in maintaining unproductive hands. . . . Such people, as they themselves produce nothing, are all maintained by the produce of other men's labor. When multiplied, therefore, to an unnecessary number, they may . . . consume so great a share of this produce, as not to leave sufficiency for maintaining the productive laborers. . . ." (Random House, 1937, p. 325)

Now What?

First we must admit that there are *no* funds in the "Trust Fund." The money has been commingled with other Federal revenues and spent. (The federal government runs multi-billion-dollar deficits, which include Social Security receipts and disbursements, so it can't have net savings.) Social Security hasn't been made "solvent"; it remains the same bankrupt pyramid scheme it has been all along. The problem has only been compounded by creating yet another pyramid scheme with which to finance the first.

Next we have to identify our real goal. It is not to salvage a particular program, nor is it to pile up mountains of paper money. The goal is to create sufficient *real wealth* to support people in their old age. Stated this way, it becomes clear that the issue is one of increasing production.

This can best be done by ending Social Security and allowing people to provide for their own retirements by investing their own money in real, productive capital through private banks, pension plans, and corporate stocks and bonds. Only through such private investment can we provide the capital to expand our industrial base.

In less than 150 years, the free market increased productivity so much that child labor could be stopped. Individuals, who previously had to work all their waking hours to earn a bare existence, now can support an entire family with only 40 hours of labor a week. The elderly, who had had to work until their deaths (or, in some pre-industrial societies, were left to die when their usefulness ended), can now look forward to retirement.

There is no reason why in the computer age the free market cannot continue this spectacular progress begun in the machine age. The market can provide the elderly with the material goods they need, but only if it is allowed to work. Only through *real* saving—producing more than we consume —can we provide for the future. We cannot do it by amassing paper dollars and Treasury notes. □

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U.S. Trade Deficits Aren't a Problem

by Roger Nils Folsom and Rodolfo Alejo Gonzalez

Every U.S. trade deficit report brings forth myriad lamentations, routinely linking the deficit to the widely heralded notion that because foreigners allegedly now own more U.S. assets than we own foreign assets, the U.S. has become a "debtor" nation. Suppose this allegation is true and foreigners do own more stuff here than we own there. Does that situation really reflect debt that eventually we must repay?

Although recent data suggest that our trade deficit has begun to decline, it still is huge, and questions about its origins and consequences remain. What caused our trade deficit, and why haven't we stopped it? Won't foreign-owned assets cause us problems when exchange rates change? Isn't our trade deficit evidence of shameful profligacy? If foreigners own more here than we own abroad, how will we pay them a return on their assets? Could our trade deficit continue indefinitely—will it ever become a surplus? Wouldn't a shift from trade deficit to surplus require the dollar's foreign exchange value to fall even more than it has in the recent past? And what about the federal government's budget deficit?

Professors Folsom and Gonzalez teach in the Department of Economics, San Jose State University. *They are particularly indebted to Heather Folsom, who at age 10 posed the fundamental question that gave rise to this essay. They wish to thank Kirk Blackerby, Betty Chu, Mario Escobar, Anna K.N. Folsom, David Henderson, Franz Hirner, J. Paul Leigh, John Navas, Geoffrey Nunn, Michael Pogodzinski, Tim Sass, and David Saurman for their suggestions; Ralph Kozlow and Russell Scholl for explanations of international economic data; Ann Arlene Marquiss Folsom for her editing; and participants at the March 1989 National Social Science Association convention at Reno, Nevada, where they presented an earlier draft, for critical comments. The authors alone are responsible for the views expressed here.*

Deficits and Debt

A 10-year-old at dinner posed the first, fundamental question: "Even if we import more than we export, if the exports and imports are paid for, where does the *debt* come from?" The question implies the answer: Of course debt comes only if our trade deficit isn't paid for. And we are paying for our net imports by selling all sorts of assets (real and financial, non-debt and debt) to foreigners. These asset sales need not put the U.S. in debt internationally, just as domestic asset sales need not put us in debt domestically. (Some examples: Selling your house doesn't put you in debt. If you own a mortgage on someone else's house, selling that mortgage won't put you in debt, and won't increase his debt, either. And kicking down all the "for sale" signs in your neighborhood, because you don't want your neighborhood to be indebted to outsiders from other neighborhoods, makes no sense.)

Trade means exchange. If we export less to foreigners than they export to us, they must be getting something else from us to compensate. Our "current account" goods and services trade deficit is inevitably balanced by our foreign investment surplus. If our (broadly defined) exports are less than our imports, then foreign private individuals, firms, or governments must be accumulating more U.S. assets (either real or financial assets, short or long term) than U.S. individuals, firms, or governments are accumulating foreign assets.

Although conventional wisdom assumes that our trade deficit causes our foreign investment surplus, our trade deficit could just as well result from our foreign investment surplus. Actually, our trade

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deficit and investment surplus are determined simultaneously, as people choose to export, import, and invest at home or abroad. Incidentally, the dollar value of U.S.-owned assets abroad has increased in every year since at least 1960, although a decrease would mean merely that Americans preferred to invest at home. Our foreign investment surplus occurs because foreign-owned assets in the U.S. are increasing even more rapidly.

Voluntary Transactions

That we are financing our trade deficit by selling assets to foreigners may sound disastrous. But our trade deficit and foreign investment surplus reflect voluntary market transactions from which each party expects to benefit, or else the transaction wouldn't occur. We have a trade deficit because we think we benefit from the transactions that generate it, and the foreigners with whom we trade think they benefit. Both sides generally do benefit.

Note that if we were running a trade surplus, for example by exporting more automobiles than we imported, we still would be selling assets—automobiles—to foreigners, again to the benefit of both sides. Also note that the automobile assets that we could be selling abroad, and the real and financial assets that we in fact are selling abroad, all use or represent scarce economic resources.

This similarity is obscured under the definitions currently used in international "balance of payments" accounting. An American-made automobile sold abroad counts as an export and hence reduces our trade deficit (and foreign investment surplus), while a building constructed in the U.S. but sold to a foreigner counts as foreign investment in the U.S. and hence increases our trade deficit (by increasing our foreign investment surplus). Yet there is no real difference between these transactions, other than that the automobile physically moves abroad while the building remains here.

Even though both sides benefit from their voluntary market transactions, there may be some different set of transactions, other than the ones actually agreed to and carried out, that would yield even greater benefits. We don't make the Pollyanna claim that any particular set of voluntary market transactions generates the best of all possible worlds; the most advantageous trades may be overlooked. Voluntary market transactions simply make both sides better off than they would be without the transactions.

Those Profligate Americans

Despite many wails to the contrary, neither our many imports nor our net trade deficit show us to be frivolous and profligate. Most of our imports are consumer goods, but we also import many capital goods such as industrial machinery, trucks, and construction equipment. Moreover, many "consumer goods" imports such as automobiles and even home electronics could be considered capital goods because, just like a lathe or milling machine, they last and produce services for a long time. Even short-term imports such as food, flowers, or quickly broken toys can add to the stock of real capital in the United States. The more we import of anything, the more domestic resources we have available for production of other commodities, including real capital goods. Some of what we buy may be judged foolish, but purchases don't become foolish merely because they are imported.

Foreign-Owned Assets

Won't we have to pay back the foreign investments now being made in the U.S.? No. Foreigners are buying many kinds of real and financial assets. If they buy real estate, they own it now, so we won't have to pay anything back. If they buy equities in businesses, they own those equities now, so again we have nothing to pay back. If they buy private debt, for example General Motors bonds, General Motors will have to pay neither more nor less than if the bondholders were Americans. If foreigners buy U.S. government debt, the U.S. government will have to pay neither more nor less than if the debt were owned by Americans. If foreigners hold U.S. bank accounts (denominated in either dollars or foreign money), the bank's liabilities are no greater than if these accounts were owned by Americans. All of these assets pay a return (an implicit return in the case of non-interest bearing bank accounts) to whoever owns them, but there is nothing additional to be paid back, paid off, or paid out.

Admittedly, foreign willingness to lend to Americans may induce us to borrow more than we would otherwise. In this sense, some of our trade

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deficit is being financed by new borrowing. But new borrowing from foreigners should cause no more problems than would new domestic borrowing. If some Americans borrow and waste the proceeds, they become worse off (as do the lenders if the borrowers default), but whether the lenders are domestic or foreign makes no real difference. Of course, if exchange rates change, speculators who hold portfolios of net assets denominated on balance in moneys that unexpectedly depreciate, or net liabilities denominated on balance in moneys that unexpectedly appreciate, will lose, but those losses will be balanced by others' gains.

(Even a growing international debt wouldn't imply impoverishment because the proper measure of wealth is assets minus liabilities, not assets or liabilities alone. U.S. wealth continues to rise, because U.S. domestic saving—even after deducting all government budget deficits—remains positive.)

Where will the output come from to pay the returns on the assets in the U.S. now owned by foreigners? This is an irrelevant question, since, if a foreign-owned asset is productive, its return accrues to its foreign owner; if it isn't productive, that is the foreign owner's problem, not ours. And the foreign investment was accompanied by enormous inflows of resources (remember our huge trade deficit) resulting from exchanges to which we would not have agreed unless we expected to benefit, presumably by increasing our productive capacity or at least our economic welfare.

No other society coerced us to import more than we export and to accept huge volumes of foreign investment. We aren't a pre-perestroika Eastern European nation "trading" with the Soviets. Voluntary foreign investments accompanied by resource inflows can pay their own returns. Foreign purchases of U.S. assets aren't a zero-sum activity, since increases in foreign-owned assets require neither a decline in U.S.-owned assets nor a rise in U.S.-owed liabilities. Descriptions of the U.S. as a "debtor nation" are unwarranted.[1]

Trade Deficit or Surplus?

As foreigners reap their returns from owning U.S. assets, our current trade deficit could be followed by a trade surplus if foreigners choose to consume their returns or invest them outside the U.S., but these choices and a resulting trade surplus aren't inevitable. Capital that flowed in need not flow out again. Foreigners could continue to reinvest their returns here. Many U.S. assets are owned by foreigners who want not to repatriate profits but to accumulate even more assets in the U.S., where private ownership rights are relatively more secure than in their home countries.

Thus our trade deficit and foreign investment surplus could persist indefinitely. Real capital flows to wherever the expected real rate of return is highest, and apparently it has been and continues to be higher in the U.S. than elsewhere. Eventually, in a static world, the inflow of capital would reduce U.S. rates of return to equal those elsewhere, and the inflow would cease, but "cease" doesn't mean "reverse." In any case, the world isn't static. Even if rates of return around the world eventually did equate, additional saving and investment would upset these equalities. The highest of the new rates of return would attract the new investment, creating new trade patterns in which the U.S. conceivably could have either a trade deficit and foreign investment surplus, or a trade surplus and foreign investment deficit.

A U.S. trade surplus will follow the current U.S. trade deficit only to the extent that foreigners consume or invest abroad their U.S. assets' returns, instead of reinvesting them here. Even then, if foreigners move or sell title to their U.S. assets across national boundaries, our current trade deficit with one country could be followed by a trade surplus with another country—or by no trade surplus at all, if foreigners follow their capital and migrate here, or sell their U.S. assets to other foreigners who migrate here.

For a Trade Surplus, Must the Dollar's Value Decline?

For the U.S. to develop a trade surplus (and foreign investment deficit), the value of the U.S. dollar relative to foreign money need not decline. A drop in the dollar's international value does make our exports more competitive and our imports more expensive, but it also makes our assets more attractive to foreigners and foreign assets less attractive to us. The net effect on our trade deficit and foreign investment surplus is ambiguous. We could develop a trade surplus without the dollar falling at all, or even if the dollar's value rose.

Recall that the U.S. trade deficit (imports into

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the U.S. minus exports from the U.S.) necessarily equals the U.S. foreign investment surplus (foreign investment inflow into the U.S. minus U.S. investment outflow abroad). A drop in the dollar's international value encourages U.S. exports by making them cheaper to foreigners, and discourages U.S. imports by making them more expensive to us. If the dollar drops, the dollar value of our exports will certainly increase, but the dollar value of our imports will decrease only if we cut them enough to compensate for the higher dollar prices we pay. Thus a drop in the dollar's value will reduce our trade deficit (measured in dollars) only if our exports increase enough to offset any increase in the dollar value of our imports. That is, a drop in the dollar's value will reduce our trade deficit only if either our exports or our imports are sufficiently responsive to exchange rate changes.[2] Otherwise, if a drop in the dollar's value decreases our imports too little or increases our exports too little, then our trade deficit will increase instead of decrease. So much is well known, at least among those who have spent some time thinking about the effect on trade deficits of exchange rate changes.

When the Value of a Dollar Drops . . .

Less frequently considered is the effect of exchange rate changes on the components of our foreign investment surplus. A drop in the dollar's value affects international investment flows as it affects exports and imports. A drop encourages foreign investments in the U.S. by making them cheaper to foreigners, and discourages U.S. investments abroad by making them more expensive to us.[3]

It could be argued that foreign investment is relatively insensitive to exchange rate changes. For example, with a drop in the dollar's international value, expected to be temporary, foreigners would be especially eager to buy U.S. assets but Americans would want to postpone asset sales until the dollar returned to a higher "normal" value. If these motivations offset each other, asset sales wouldn't change.

Even a permanent drop in the dollar's international value could have little effect on foreign investment, because the demand for an investment asset presumably depends on its expected rate of return, which—it often is supposed—is unaffected by a permanent change in exchange rates. A permanent drop in the dollar's international value reduces the price of U.S. assets in terms of foreign money, but it also reduces the future income that will be earned by that asset in terms of foreign money.

However, if foreigners have any expectation that they will spend any of their future returns in the U.S., then a drop in the value of the dollar—even if expected to be permanent—does make U.S. assets more attractive to foreigners. And if the resulting increase in foreign demand raises the dollar price of U.S. assets, Americans are encouraged to sell (despite the decline in the dollar's international value) if they expect to spend any of the proceeds of their asset sales in the United States. Only if Americans expected to spend all asset sale proceeds abroad would they be indifferent to the higher dollar prices for U.S. assets offered by foreigners when the dollar's international value goes down.

Thus if the dollar's international value drops, the dollar value of foreign purchases of U.S. assets will almost certainly increase, and the dollar value of our asset purchases abroad will decrease if we cut them enough to compensate for the higher dollar prices we pay. A drop in the dollar's value will increase our foreign investment surplus, unless we cut our asset purchases abroad so little that their dollar value increases, and increases enough to offset foreigners' increased asset purchases in the United States.

A drop in the dollar's value will decrease our foreign investment surplus (and hence our trade deficit) only if foreigners increase the dollar value of their asset purchases here less than we increase the dollar value of our asset purchases abroad. A drop in the dollar's value will reduce our trade deficit and foreign investment surplus only if either foreign purchases of U.S. assets or our purchases of assets abroad are sufficiently *un*responsive to exchange rate changes.[4] Otherwise, if a drop in the dollar's value increases foreign purchases of U.S. assets too much, or decreases our purchases of assets abroad too much, then our trade deficit and foreign investment surplus will increase instead of decrease.

Those who *forecast* that the dollar's international value will drop farther on the assumption that the trade deficit must end, and also those who *advocate* a further drop in order to force our trade deficit to end, are assuming not only that exports

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or imports are highly responsive to drops in the dollar's value, but also that net foreign investment flows aren't highly responsive to drops in the dollar's value. When both trade and investment flows are considered, the effect of exchange rate changes on foreign trade deficits and foreign investment surpluses becomes much less obvious.[5] Ultimately, the issue becomes an empirical question.

A drop in the dollar's international value could reduce our trade deficit and foreign investment surplus, by making our exports more competitive and our imports more expensive. But a drop in the dollar's international value could instead enlarge our trade deficit and foreign investment surplus, by stimulating foreign investment here and discouraging U.S. investment abroad. Although recent trade statistics suggest that the drop in the dollar's international value since February 1985 is beginning to reduce our trade deficit and foreign investment surplus, an end to our trade deficit certainly doesn't require the dollar's value to drop more.

For example, without any drop in the dollar's international value, our trade deficit could end and even become a surplus either because foreigners simply decide to buy more of our exports while investing less here, or because we decide to import less while investing more abroad. (Such decisions could result from changes in weather patterns and agricultural productivity, industrial productivity, new inventions and technologies, reliability of alternate suppliers, safety of investments in various countries, government domestic and trade policies, perceived goods' quality, consumer tastes and preferences, and so forth.) Regardless whether we sell foreigners more commodities and fewer assets, or we buy from them fewer commodities and more assets, neither the demand for nor the supply of dollars on foreign exchange markets need change, so the dollar's foreign exchange value need not change.

All parts of the U.S. use the same money, yet resources have flowed from New England to real investments in southern and southwestern states, and then have stopped flowing and even reversed direction. The fixed exchange rate between the New England dollar and the rest-of-the-U.S. dollar, constant for more than 200 years, has facilitated rather than impeded such resource movements within the U.S. by eliminating the risks of fluctuating exchange rates.

The nonhuman capital we have been discussing can move even if the owners of that capital stay put; human capital cannot move unless its owners migrate. Somehow that difference muddles our thinking and prevents us from seeing the similarities. Propositions that apply neither to labor nor non-labor resources we correctly reject for human capital but wrongly accept for nonhuman capital.

Not only foreign non-labor resources but also foreign people have come here. Do we need to "pay back" this labor inflow, by sending our children abroad against their will? No. Must we have extra children, in order to create a surplus to pay off our "immigration deficit?" No. Is our trade deficit an imaginary problem worried about by hallucinating minds? Yes.

Government Budget Deficits

What about our high government budget deficits and low (but still positive) saving rate? In years past, when almost all government debt was owned by Americans, government budget deficits seemed less threatening not only because they were smaller (and saving was relatively higher) than now, but also because "we owe it to ourselves." Now that foreigners own about 20 percent of U.S. government debt, that saying is less accurate and less comforting.

But even in years past, "we" and "ourselves" were different people. Regardless how much government debt is held domestically or by foreigners, government debt and the interest on that debt can be paid only by taxes or by defaulting—either outright, or by inflating the debt's value away, or, in the case of foreign-held debt, by a drop in the dollar's international value. Each of these alternatives would affect different people differently. Some will gain while others lose; nobody's wealth is likely to be unaffected.

Foreign trade "deficits" and government budget deficits are entirely different concepts. Foreign trade deficits and investment surpluses result from voluntary market exchanges of goods, services, and assets; government budget deficits arise from government spending financed by fiscal and monetary policies that government coercion imposes on individuals in the society. And unlike foreign trade deficits financed by foreign investment surpluses, government budget deficits really do generate debt (either interest-paying bonds or non-

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interest-paying money) that will be financed by coercion (taxation or some sort of default). Compared with trade deficits, there is less assurance that government budget deficits are benign.

The U.S. government budget deficit and foreign trade deficit are often described as "twin deficits," implying that the budget deficit's adverse consequences are worsened by the foreign trade deficit—that is, by the foreign investment surplus that helps finance the budget deficit. But this view is seriously misleading because it forgets that the trade deficit results from voluntary market transactions, while the government budget deficit does not. Given the magnitude of the budget deficit, it isn't more serious merely because foreigners finance part (or even all) of it, since, without a foreign trade deficit and investment surplus, gross investment in the U.S. would be less. (If anything, the government budget deficit's consequences are alleviated, not worsened, by the trade deficit.) If the government budget deficit is too high, it is too high no matter whether it is financed by U.S. residents or by foreigners, no matter what the size of the foreign trade deficit. The trade deficit doesn't compound the government budget deficit.[6] □

1. Incidentally, although asset ownership estimates state that foreigners own more assets here than we own abroad ($1,786.2 billion versus $1,253.7 billion at the end of 1988), this comparison is questionable because other data show the U.S.receiving $2.2 billion of net foreign income in 1988. Unless Americans are consistently more sagacious investors than are foreigners, something is wrong—if they own so much more here than we own there, our net foreign income should be negative rather than positive. All these data are suspect, but the asset ownership data are especially suspect, because they undervalue U.S.-owned assets abroad by not fully allowing for appreciation since those assets were acquired, many of them long ago. "U.S. assets abroad are primarily direct investments that have been accumulated much earlier than foreign direct investment holdings in the U.S. and are recorded, for the most part, at their acquisition value, not at their current market price. As a consequence, the recorded value of foreign investment in the U.S. is less understated relative to its market value than is that of U.S. investment abroad.... It has been estimated by two State Department economists that U.S. foreign direct investment was undervalued by between $400 billion and $600 billion as of the end of 1987." Mack Ott, "Trade Deficit Myths," *The Wall Street Journal*, January 19, 1990.

2. More precisely, a drop in the dollar's value will decrease our trade deficit if and only if the weighted sum of the elasticities of our export quantities plus the elasticities of the dollar prices we receive for our exports *exceeds* the weighted sum of the elasticities of our import quantities plus the elasticities of the dollar prices we pay for our imports, with each elasticity weighted by the dollar value of its (export or import) transaction. These elasticities are the percentage change in quantities or dollar prices with respect to a percentage change in the international value of the dollar. (If the trade deficit is close to zero, and if the elasticity of the dollar prices we receive for our exports is zero while the elasticity of the dollar prices we pay for our imports is unity, this condition becomes simply that the weighted export and import quantity elasticities sum to *more than* one in absolute value.)

3. We ignore the effect of exchange rate changes on expectations, particularly expectations about future exchange rates and prices.

4. More precisely, a drop in the dollar's value will decrease our foreign investment surplus if and only if the weighted sum of the elasticities of the quantities of our asset sales to foreigners plus the elasticities of the dollar prices we receive for selling these assets is *less than* the weighted sum of the elasticities of the quantities of our asset purchases abroad plus the elasticities of the dollar prices we pay for assets abroad, with each elasticity weighted by the dollar value of its (asset purchase or sale) transaction. (If the investment surplus is close to zero, and if the elasticity of the dollar prices we receive for our asset sales to foreigners is zero while the elasticity of the dollar prices we pay for our asset purchases abroad is unity, this condition becomes simply that the weighted quantity elasticities of our asset sales to foreigners plus our asset purchases abroad sum to *less than* one in absolute value.) These elasticities are the percentage change in quantities or dollar prices with respect to a percentage change in the international value of the dollar.

5. Some readers may remember some variant of the condition in note 2 (or note 4) above as a foreign exchange market stability condition, necessary and sufficient to make the elasticity to acquire and hold dollars, with respect to the international value of the dollar, negative. However, this is a stability condition only in models in which a money such as dollars is the only asset. In the present context, with exports, imports, non-money assets, and foreign money all trading against dollars, the stability condition would be that the weighted sum of the elasticities of the quantities of our exports *and* assets (other than dollars) sold to foreigners plus the elasticities of the dollar prices we receive for these sales exceeds the weighted sum of the elasticities of the quantities of our imports *and* assets (other than dollars) purchased abroad plus the elasticities of the dollar prices we pay for these purchases, with each elasticity weighted by the dollar value of its (export, import, or asset purchase or sale) transaction.

If money were the only asset, it might be reasonable to suppose that any trade deficit eventually would end. As the residents of the trade surplus country received more and more of the trade deficit country's money, eventually their demand for it would begin to become satiated and hence highly inelastic. Rather than continue accumulating trade deficit country money, trade surplus country residents would reduce their sales to the trade deficit country, or else increase their purchases from it, enough to end the trade imbalance. But this argument doesn't apply to a world containing a variety of assets, for which the total demand isn't likely to become satiated.

6. The opposite argument—that a large government budget deficit enlarges the foreign trade deficit and foreign investment surplus by raising U.S. interest rates—is plausible. However, the connection, if any, between budget deficits and interest rates depends on why the deficit is large—for example, whether an enlarged deficit results from an economic recession, a tax cut, an expansion of government spending on transfer payments, or an expansion of government spending on goods and services. (A recession tends to lower interest rates; economic expansion tends to raise them.) Similarly, an attempt to reduce the budget deficit could either lower or raise interest rates, depending on whether the deficit were reduced by a tax increase, lower government spending on transfer payments, or lower government spending on goods and services. It also would depend on how people reacted to the deficit-reducing policy, specifically whether U.S. private saving, and foreign investment in the U.S., rose or fell. Ultimately, interest rates are determined by the relative magnitudes of total saving (supply of loanable funds) and investment (demand for loanable funds), although many policy discussions seem to forget this fundamental.

Empirically, most deficit increases and decreases result from a combination of causes. Consequently, and not surprisingly, empirical studies generally don't support a straightforward "larger deficits raise interest rates" hypothesis.

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Readers' Forum

To the Editors:

I read with interest Barbara Sall's article "Trickle Up: A Solution to Third World Poverty" in the April 1990 *Freeman*. While I believe that programs such as TUP do much to improve conditions for the poor, I think that TUP and other programs like it fail to address fundamental problems in the poor's access to credit. As a result, they can scarcely be called a solution to poverty but are at best a palliative. And at worst, by pretending to solve the problem, they distract attention from the real impediments to poor entrepreneurs in the Third World, and delay the implementation of policies that would truly rectify the situation.

By and large, these programs rely on charitable assistance to provide credit for the poor. But why don't the poor have access to domestic credit? The answer is to be found in Hernando de Soto's research in Peru. He has pointed out that the unavailability of credit to the poor is related to their lack of access to the legal system.

One of the requirements for acquiring a TUP grant is that the grantees must be able to secure the necessary government approvals and licenses. But, what happens when it takes 289 days of full-time effort to acquire such a license? What good is a micro-enterprise loan or grant when the costs of obtaining all the necessary government authorizations in a lawful manner rise to several times annual per capita income in the poor countries? (Hernando de Soto has shown this to be the situation for informal entrepreneurs in Peru.)

A long lasting and effective way of ensuring that the poor have access to credit is found in removing the legal and institutional obstacles placed in their way by mercantilist economic systems, and by fostering intermediary institutions so that they may have access to the legal and financial systems on a permanent basis.

Graciela D. Testa, Editor
International Health & Development
Washington, D.C.

Barbara Sall replies:

Graciela Testa has made some very important and positive points concerning the need to reform the legal and economic impediments to development in Third World countries. In fact, these needs were reiterated by Melanie S. Tammen, a policy analyst with the Competitive Enterprise Institute in Washington, D.C., in the June edition of *Reason* magazine.

Tammen refers to Hernando de Soto's pioneering book, *The Other Path*, which "explains why only legal and regulatory reforms will permanently enfrachise Peru's microenterprisers. . . ." So persuasive are de Soto's and others' arguments on the need for massive reforms in the way Third World countries do business, that even the World Bank is calling for legal reforms that would "make it easier to small enterprises with relatively large financial needs to use formal services."

But calling for a significant change in legal and economic policies that would allow very poor people to compete with the large family monopolies that are the beneficiaries of bureaucratic, legal, and regulatory controls is one thing—obtaining results that will bring in the little bits of money necessary to get poor families through one more day is another. Denying tiny enterprises their first chance at self-sufficiency for the long-range goal of changing hundreds of years of repressive policies may be impossible for people like the Leets, directors of the Trickle Up Program, to handle.

Instead, I would prefer to believe that the pressure of newly successful small entrepreneurs will be greater than any milquetoast reform guidelines imposed by the World Bank, AID, and other international development agencies. I seriously doubt that large Third World aid corporations will cease their number one task—that of funding the very regimes that deny credit and financial empowerment to the very poor.

The power of thousands of self-sufficient families, however, now able to educate their children and employ dozens of their relatives, to push for these extremely important reforms should not be underestimated. Likewise, the dismal track record of international aid organizations and reform-minded politicians in Third World countries should not be forgotten. As we have found only too often in this country, the removal of barriers to economic growth imposed by government is one of the most difficult tasks of a free people. It only becomes possible if those people have the ability to feed, educate, and shelter themselves. Any assistance toward those ends, such as the Trickle Up Program, will hopefully work toward the final goals expressed so well by Graciela Testa.

Barbara L. Sall
Boise, Idaho

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A REVIEWER'S
NOTEBOOK

The Quest for Community

by John Chamberlain

The Quest for Community, subtitled "A Study in the Ethics of Order and Freedom," was written in the 1950s by Robert Nisbet, a professor of sociology at Columbia University. Originally published by the Oxford University Press, it has now become part of the "ICS series in self-governance" published by the Institute for Contemporary Studies (243 Kearny Street, San Francisco, CA 94108, 272 pages, $10.95 paper).

The book is confusing because pluralism, which Nisbet welcomes, is in itself confusing. As George Roche of Hillsdale College has said, we live in a "bewildered society." We come out of a 19th century in which men believed in individualism. They were satisfied to take status from membership in the "intermediate" organizations of the family, the church, the private school, the labor union, the sports club, the dramatic society, and so on. For the rest, they were happy in a world that believed in something called "progress." Community took care of itself.

But Tocqueville, that prophetic French visitor of the early 19th century, sensed troubles to come. Democracy was fine, but there could be tyrannies of the majority. The Founding Fathers, in dividing the powers of government, had done their best. But community was not a matter of elections and parliaments. It was a matter of man's relation to the cosmos in which we all must live.

Tocqueville worried about the strong drives of individualism and Statism which seemed to put inexorable pressure from two ends of the scale on the "intermediate" organizations. He saw the State stepping in to assume powers that should belong to groups of citizens. Unfortunately, citizens can be passive. The State didn't have to be the wicked enemy of mankind that figures in the writings of Mencken and Albert Jay Nock. It didn't have to be vicious, as in Hitler's Reich or Stalin's gulags. It could aspire to be total in a nice way, with negligence taking over. But what of freedom? Tocqueville thought we could be conned out of it.

"Because of our single-minded concentration upon the individual as the sole unit of society," Nisbet writes, "and upon the State as the sole source of legitimate power, we have tended to overlook the fact that freedom thrives in cultural diversity, in local and regional differentiation, in associative pluralism, and above all, in the diversification of power.

"Basically," Nisbet continues, "all of these are reducible . . . to the single massive problem of political government to the plurality of cultural associations which form the intermediate authorities of society. . . ." Nisbet reworks this theme of diversification by quoting from a score of people to make the same point. Bertrand Russell, Montesquieu, Lord Acton, Proudhon, Frank Tannenbaum, David Lilienthal, Karl Mannheim, Lewis Mumford—all of them are lined up as proponents of setting unit against unit, power against power. The grand enemy is Rousseau's General Will. Decentralization is the word that can link anarchists (Proudhon), engineers (Lilienthal), and old-fashioned liberals together.

William A. Schambra, in his introduction to the new edition of *The Quest for Community*, says that Nisbet's work "stands among the most important social critiques ever written." There is no denying that every page of the book has provocative sentences. But the proliferation of quotations from so many other primary social critics gives Nisbet's

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work the flavor of an anthology. Nisbet doesn't grant his readers the right to say, "Hey, you've made the point sufficiently strong in your own words. Why drag in all the corroborative voices?"

The justification for Nisbet's method is that it teaches. And Nisbet is first of all a teacher. Since he obviously hasn't found his "community" (he is still "questing"), he would be the last to claim the originality that Kant made the mark of the true creator. Nisbet would probably be satisfied to be known as a good teacher of the values underlying the free society. He can leave the hyperbole to others. □

DISCOVERY, CAPITALISM, AND DISTRIBUTIVE JUSTICE

by Israel M. Kirzner

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Reviewed by Charles W. Baird

In three earlier books (1973, 1979, and 1985), Israel Kirzner developed his positive theory of market process which, he convincingly argued, is superior to neoclassical comparative statics as a framework for understanding how markets work in the real world. In the present book he employs the insights of his positive analysis to build a brilliant new theory of distributive justice, which he calls the "discovery theory of justice."

Just about everyone these days agrees that capitalism (meaning an economic system based on private property and voluntary exchange) does a better job of creating wealth than any other known economic system. But far too many still allege that capitalism fails to distribute that wealth equitably. Even the best known, and most respected, efforts to defend capitalist distribution—e.g., J. B. Clark's marginal productivity theory and Robert Nozick's entitlement theory—fail to convince the doubters. While Kirzner's arguments won't persuade all doubters, they are likely to reduce their ranks greatly.

The book is organized into seven easy-to-read chapters. In the first, Kirzner introduces his theme and outlines his argument. In chapters 2 and 4, he develops the key concept of discovery and explains its role in ongoing market processes. More about this later.

In chapter 3, Kirzner demonstrates that the discovery principle was overlooked by economists J. B. Clark, F. B. Hawley, Frank Knight, and Joseph Schumpeter. Surprisingly, according to Kirzner, even Ludwig von Mises failed to grasp the normative implications of discovery. Although Mises' economic analysis incorporated the discovery principle, he defended capitalist distribution merely on utilitarian grounds. Philosopher John Rawls' view of economics is in the neoclassical tradition of welfare economics. Market processes and discovery are completely foreign to him. Although Robert Nozick's entitlement theory is consistent with a market process view of economics, he fails to incorporate any discovery concepts.

In chapter 5, Kirzner makes the case that once the role of discovery is fully understood, the well-known finders-keepers rule is seen to be applicable to the normative evaluation of capitalist distribution. In chapter 6, he defends the finders-keepers rule as a "widely shared ethical intuition" and shows how it overcomes the weaknesses of Nozick's entitlement theory. Finally, in chapter 7 he points out some of the questions—e.g., the problem of rectification of past injustice—which the discovery principle is incapable of answering.

My only substantive criticism of the book is that chapter 3 seems out of place. Chapters 2 and 4 naturally go together. So far as I can see, chapter 3 could easily follow chapter 4 without any disadvantage. It makes better sense to search for discovery in the work of others after discovery and its place in the market process have been fully explicated.

That said, the argument of the book is compelling. Briefly, and incompletely, it goes like this. There are two kinds of ignorance that every individual must cope with in the real world—ignorance of which one is aware and ignorance of which one is unaware. The first involves things which we know we don't know. We remain ignorant of some things by design simply because we don't think it is worth the trouble to find out about them. This sort of ignorance can be dispelled by deliberate search for the missing knowledge. It is the kind of ignorance that neoclassical economists address in the literature on information costs and search.

The second kind of ignorance, what Kirzner calls "sheer ignorance," refers to things that we don't know that we don't know. We simply have no inkling that any knowledge is missing. In many cases of sheer ignorance we would place a high value on the missing knowledge if it ever came to our

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attention. We just fail to notice it or fail to see that it would be worthwhile to obtain. Sheer ignorance is dispelled by discovery. Discovery involves no deliberate deployment of resources in search; it comes spontaneously to those who are alert to new possibilities. A discoverer envisions a possible alternative state of affairs that he considers superior to the status quo. In other words, a discoverer is an entrepreneur who notices a hitherto unnoticed profit opportunity.

The next important distinction is between pure production and discovered production. In the former, a fully specified set of inputs is transformed into a fully specified output. This is the concept of production in neoclassical theory. Here it can be said that possession of the inputs guarantees possession of the output. The set of all inputs that are necessary (in the engineering input-output sense) for the physical production of the output can be considered inchoate output. The output can be attributed solely to the contributions made by each of the necessary inputs to the final product. This, indeed, is the basis of J. B. Clark's marginal productivity theory of factor incomes.

But in the real world things are not so simple. Given inputs aren't mechanically transformed into given outputs. Before any such physical transformation takes place someone has to envision the possibility that such production would be worthwhile. Someone has to discover the production possibility, assemble the necessary resources, and deploy the inputs. Desirable output goals and necessary means to those goals are not "given" to anyone. Discovery is the originative act upon which everything else depends.

Entrepreneurial alertness is fueled by the prospect of pure profit. Pure profit is defined as the difference between the price at which the output is sold and the sum of the prices paid for all of the inputs necessary, in the engineering input-output sense, for production. Entrepreneurship, therefore, is *not* a resource in the sense of neoclassical production theory. The pure profit gained by a successful entrepreneur cannot be defended as a Clarkian marginal productivity resource income.

But entrepreneurship *is* necessary for production in the sense that entrepreneurial discovery is the originative act upon which all production depends. In this sense it can be said that entrepreneurship is responsible for the whole of the final product. A successful entrepreneur discovers a profit opportunity. Before the opportunity was discovered it did not exist in any economically significant sense. The discoverer can be said to have *created* the possibility, and it is a widely shared ethical intuition that a person who brings something into existence has a just entitlement to it.

Moreover, entrepreneurial discovery amounts to creation *ex nihilo*. The entrepreneur does not deliberately deploy any resources in discovery. The entrepreneur simply notices that which hitherto has been overlooked by everyone. The entrepreneur finds the profit opportunity, and, if we subscribe to the widely shared ethical intuition called the "finders-keepers" rule, we must conclude that the entrepreneur has a just entitlement to the pure profit that results.

Here I have a quibble. In chapter 2, Kirzner explains the difference between discovery and search. He writes, "One may, as a result of searching, 'find' something valuable that one sought. But the verb 'to find' in this context, is not at all the same as the verb 'to discover.'" In chapter 5 he adopts "finders-keepers" as the name of the ethical principle upon which to base his discovery theory of justice. This seems contradictory. Presumably he uses "finders-keepers" because that is the common name attached to the idea. But precisely because the name is so common, some may dismiss the principle as trite. Perhaps a better name for the principle would be something like "creators-keepers" or "originators-keepers."

Lest one think that the discovery principle applies only to a relatively few people called entrepreneurs and only to one sort of income called pure profit, Kirzner goes on to explain that every income received by every transactor in a capitalist economy includes a discovery component. As Mises pointed out, and as Kirzner has often reminded us, although it is analytically useful to separate the role of the entrepreneur from the role of resource owners and the role of consumers, everybody is an entrepreneur. A seller of labor is never in the position of merely having to choose from a well-defined and ranked set of alternatives. Neither is a capitalist, a landowner, or a consumer. Markets are never in neoclassical equilibrium. No one is ever sure what the available means and ends are. All decision making is done in the presence of at least some sheer ignorance. Better employment alternatives, better investment alternatives, better purchase opportunities, and better prices all must

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be discovered. Doing the best you can for yourself, no matter what that means to you, requires alertness and entrepreneurial discovery. Discovery and the finders-keepers rule are applicable to all incomes.

One of the highlights of the book is Kirzner's discussion of supply and demand in chapter 4. Neoclassical analysis is centered on market-clearing prices and quantities—where supply and demand intersect. But most markets are out of equilibrium most of the time. Kirzner's description of the role of discovery in the actions of all transactors in any market in disequilibrium is the most complete and most convincing I have ever seen. It should accompany every lecturer's discussion of the famous scissors diagram.

Although Kirzner's discovery theory of justice is much more than a mere supplement to Nozick's entitlement theory, Kirzner deploys his theory to overcome two major objections that have been leveled against Nozick's arguments. Nozick's theory includes justice in original acquisition of titles to things and justice in transfer of such titles. Nozick uses Locke's labor theory of property to define his principle of justice in acquisition, and he bases his principle of justice in transfer on voluntary exchange. The former has been challenged on the grounds of the Lockean Proviso, and the latter has been challenged on the basis that an exchange is not truly voluntary unless all transactors give their informed consent.

According to Locke, one gets a just entitlement to an unowned gift of nature by being the first to mix his labor with the gift of nature providing that "there is enough, and as good left in common for others." In a world of scarcity, dissenters say, the proviso can never be met. Thus private property titles to what are originally gifts of nature cannot be justified. Ironically, it is only in a world of scarcity that the institution of private property is significant.

Nozick tries to escape this problem by redefining the proviso to require only that the acquisition of title not worsen the condition of others. Nozick claims that the wealth-creating characteristics of capitalism make it possible to avoid worsening the condition of others. Thus Nozick, like Mises, relies on a utilitarian defense of capitalist distribution.

Kirzner thinks, and I agree, that Nozick's modification of the Lockean Proviso isn't likely to persuade dissenters. More important, Kirzner explains that the principle of discovery makes the Lockean Proviso irrelevant. The act of mixing labor with a hitherto unowned gift of nature has to be preceded by the originative act of the discovery that such an acquisition would be worthwhile. It cannot be said that such an act of acquisition diminishes what is available to others. Before the discovery, the acquisition wasn't available to anyone.

Those who challenge Nozick's principle of justice in transfer do so on the grounds that in many ostensibly voluntary exchanges at least one party doesn't divulge all he knows to his exchange partners. Thus such exchange partners don't give their informed consent to the exchange.

For example, consider simple arbitrage. An entrepreneur notices that someone is willing to sell something at a price that is significantly lower than the price that someone else is willing to pay for it. The entrepreneur grasps the opportunity by buying low from the first person and selling high to the second person. The entrepreneur, however, could not do so if the over-eager seller knew the price that the over-eager buyer was willing to pay. Nor could the entrepreneur do so if the over-eager buyer knew the price at which the over-eager seller was willing to sell. By withholding such information, the entrepreneur makes it impossible for the others to give their informed consent. Hence, the dissenters say, the entrepreneur's gain cannot be justified.

Here again, the principle of discovery overcomes the objection. The opportunity for the low-price seller to sell directly to the high-price buyer did not exist in any practical sense prior to the entrepreneur's discovery of the price discrepancy. The buyer and the seller did not know of each other, and, moreover, they did not know that they did not know of each other. The possibility simply never occurred to them. The discovery of the possibility actually created it, and, in accordance with finders-keepers, the entrepreneur is entitled to the pure profit he created.

With the collapse of Communism, the only serious obstacle to the eventual universal adoption of the private property, voluntary exchange economic system is the continued perception by many that capitalist distribution is unavoidably unjust. Kirzner's book is a major contribution toward the correction of that perception. □

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